Union Calendar No. 57

99TH CONGRESS *1st Session*	HOUSE OF REPRESENTATIVES	REPORT 99-95

THE 1985
JOINT ECONOMIC REPORT

REPORT

OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ON THE

FEBRUARY 1985 ECONOMIC REPORT OF THE PRESIDENT

TOGETHER WITH

ADDITIONAL AND SEPARATE VIEWS

MAY 15, 1985.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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[Created pursuant to sec. 5(a) of Public Law 304, 79th Congress]

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CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC, May 13, 1985.

Hon. THOMAS P. O'NEILL, Jr.,
Speaker, House of Representatives,
Washington, DC.

DEAR MR. SPEAKER: Pursuant to the requirements of the Employment Act of 1946, as amended, we hereby transmit the Report of the Joint Economic Committee containing its findings and recommendations with respect to each of the main recommendations made by the President of the United States in his February 1982 Economic Report.

As in most previous years, the Committee did not reach a bipartisan agreement on the contents of the report. The attached document contains separate statements from the Democrats and the Republicans on the Committee. We would like to point out, however, that much progress was made in identifying areas of mutual concern and common understanding.

Both Parties believe we have experienced a strong recovery, but that it faces significant hazards, most particularly the current level of Federal deficits. Both Parties believe that certain sectors of the economy are not being reached by the recovery and that the current high value of the dollar is a direct cause of much of the unevenness. Both Parties recognize that many unemployed Americans face problems which economic growth alone would not solve. Both Parties recognize the critical contribution which Federal support of basic research makes to economic growth.

We feel that the attached report is a solid beginning for identifying additional areas of common feeling on economic issues. We hope it will lay the groundwork for bipartisan solutions on a variety of economic issues confronting the Congress in the months ahead.

Sincerely,

DAVID R. OBEY,
Chairman.
JAMES ABDNOR,
Vice Chairman.

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FEBRUARY 1985 ECONOMIC REPORT OF THE PRESIDENT

MAY 15, 1985.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. OBEY, from the Joint Economic Committee, submitted the following

REPORT

together with

ADDITIONAL AND SEPARATE VIEWS

[Pursuant to sec. 11(b)(3) of Public Law 304 (79th Cong.), as amended]

This report is submitted in accordance with the requirement of the Employment Act of 1946 that the Joint Economic Committee file a report each year with the Senate and the House of Representatives containing its findings and recommendations with respect to each of the main recommendations made by the President in the Economic Report. This report is to serve as a guide to the several committees of Congress dealing with legislation relating to economic issues.

CHAIRMAN'S INTRODUCTION

David R. Obey, M.C.

The world economy is changing rapidly and the American position in that economy—and the makeup of our own economy—is changing with it. That change has brought pain. It also brings challenge and opportunity.

There is no doubt that America's workers and firms possess the basic ability to adapt, compete, and prosper. There is no doubt that the country has the capacity to innovate to meet the challenge of the future. But there is substantial question about whether our politics and our social institutions can facilitate the needed changes.

For example, the U.S. trade deficit and tensions with Japan have been pushed to the forefront of the news over the past few months. That is understandable and the problem is very real. But, we must not be distracted from the fact that our trade deficit is largely a symptom of other, more fundamental problems which are basically "made in America." If we deal with these problems, then we will control our own economic destiny. This country can compete, and we can prosper—but only if we invest in the future, accommodate change, and pull together as a society.

Unfortunately, we have been unable to come to grips with many of our economic problems because our politics have been split for many years by a sterile and increasingly debilitating "chicken and egg" argument about what must come first—growth or equity; prosperity or social justice. We see that now in debate about the President's economic programs; and we see that traditionally in the way that Americans almost compulsively cluster around two supposedly separate sets of values and cultures.

The first set of values clusters around government, with its emphasis on problem solving—developing public policies to promote the common good and addressing concerns of social equity. The second clusters around the business world—the realm of economics, productivity, efficiency, growth, and the bottom line.

Our concerns about social justice are too often restricted to the first world; our concerns about prosperity, too often to the second. Liberals traditionally lay claim to the first set of values; conservatives, to the second.

Within these neat categories, the business world supposedly produces, the government world supposedly distributes, and they are constantly at odds.

Those attitudes and artificial divisions are not real and they need to change. Our country's first order of business should be to establish components of a strategy that will provide for sustained growth. Without new growth, there is no new wealth to share. But economic growth is not enough in and of itself. There is a higher purpose which any economic, political, or social system is supposed to serve, and that is individual and personal growth.

In a democracy, prosperity which is not shared is prosperity soon disdained. Daniel Webster accurately said that justice is the glue that holds society together. The history of this country shows that, when the broad common interest is not clearly reflected in the Nation's economic policy, there is insufficient public support for that economic strategy. We need to understand that the economy is made for people, and not the other way around. When we recognize this reality, the American economy—and, most importantly, its people—will be better able to move forward to sustained growth and prosperity.

Today, there are confusing signals being sent about our current economic situation. We are entering the third year of a robust economic recovery, the energy shocks which threatened our economy in the past seem to be behind us, and the President conveys a sense of optimism which is contagious. Yet, last year's talk of entering a "new era of prosperity" appears to have stopped—and we are still enduring unacceptably high levels of unemployment.

Reality is dawning that our recent recovery may have been built upon a very shaky foundation—the dangerous illusion of debt. That debt is borrowed from our future, and is being generated by all segments of our society.

Many Americans are living well today because of policies and actions which involve massive and unprecedented transfers of resources from tomorrow's generation to today's. We are living high on the hog, and asking our children to pick up the tab through lower future standards of living and crushing burdens of debt service.

The Federal deficit is the most obvious piece of the debt puzzle. Each year's deficit adds to the cumulative total of the national debt. That debt has doubled over the last four years, and with that doubling goes a massive increase in the yearly debt-service burden which we pass along to future taxpayers. In many ways, we are financing our current recovery by asking the Federal Government to borrow extensively to fund essential services so that households and corporations can have more after-tax income to spend now.

By itself, debt is not necessarily a problem. It all depends on what is done with the borrowed money and whether a proper balance is struck between today and tomorrow. If borrowed money is invested, and put to work in activities which yield a higher return than the annual debt service, then debt can be productive for both the borrower and the economy. But the huge sums that are presently being borrowed in America are not being sufficiently invested in America.

Corporations are increasingly borrowing to finance mergers and speculation, not new factories or capacity. Household borrowing is concentrated in credit care and consumer debt. And the Federal Government is the worst offender of all—borrowing heavily to finance current consumption, while simultaneously squeezing the life out of many of those public activities which invest in the productivity of our citizens or the competitiveness of our firms. And when the Administration tries to get some semblance of control over runaway deficits, it does so by cutting still further into investments in our future. Such shortsighted approaches only increase the risks to our long-run growth and prosperity.

Our current national addiction to unproductive borrowing is also the key to our international trade problem. Because we have developed the habit of borrowing far more than we save, we must finance our habit by tapping the savings of others. Our capital markets regularly absorb some 5 percent of the total world's savings, and over the past few years we have swung dramatically from a net creditor to a net debtor nation.

When President Reagan attended his first Economic Summit, American holdings abroad exceeded foreign assets in the United States by almost $150 billion. That surplus had been steadily built up since 1914. When the President meets with his counterparts next month in Bonn, he will represent a country which now owes money to the rest of the world. And, when the President meets at next year's Economic Summit, it is widely estimated that the United States will have a net debt to the rest of the world of around $100 billion.

Some have argued that the willingness of foreign investors to place capital in our economy is a sign of our strength and economic health relative to other countries. To some extent, that is true. But heavy reliance on foreign capital to finance our domestic budget deficits adds considerable pressure to continue our present tight-money, high-interest rate policies, and helps to keep the price of the dollar artificially high.

Under such circumstance, the "strong" dollar becomes the "uncompetitive" dollar. The double whammy of high interest rates at home and an uncompetitive dollar abroad have been devastating to our manufacturing and agricultural sectors. The world is buying too few American goods and commodities, in large part, because our policies have made it very difficult to produce in America at prices competitive on world markets.

In the short run, American consumers may benefit by lower prices for imported goods. But, over the long run, American plants move overseas; American agriculture loses foreign markets; jobs are lost. America builds up massive IOU's to foreign countries which will drain our domestic economy for decades to come, mirroring and compounding the overwhelming problems that will result from our current budget deficits. Over the long run, we are being set up for a fall.

And it is our children who are going to take the fall. It is the next generation who will have to pay back the debt we have been using to finance our present recovery.

This massive new intergenerational transfer of wealth is not only irresponsible, but it also goes against the grain of our most basic social values. As generations of immigrants have learned through their own efforts, the "American dream" is built on hard work, sacrifice, and saving today to give the next generation a "leg up" in the competitive struggle.

This country needs to confront reality—NOW. We need to make some tough choices about the future, or we may not like the future which is thrust upon us. The Federal Government has been disinvesting in the future over the last six years. Only one category of the budget has truly been cut in both real dollars and in the percentage of the budget dollar allocated to it. That is the investment portion of the budget. If we accept the President's budget this year, in six short years, America will truly have been taken halfway to the goal of some people in this society of simply defending the shores, delivering the mail, and writing retirement checks.

Our present path of excessive borrowing, huge trade and budget deficits, and declining competitiveness can lead only toward a troubling future for our children. We need to refocus our energies on the future—on needed investment (both human and capital), on adequate savings, on efficient use of human and financial resources, and on the kinds of economic arrangements which encourage growth, equity, competitiveness and opportunity, and public acceptance.

We must make a fundamental decision about whether we do or do not need the kind of military buildup that we are embarked upon. If we do not, we should scale it back. If we do, we should be willing to pay the bill.

If we do these things, we will be building for the future—a strong and competitive America. If we do not, we will continue to be taking from the future, living on borrowed money, and, most likely, on borrowed time.

VICE CHAIRMAN'S INTRODUCTION

James Abdnor, U.S.S.

Republican Members of the Joint Economic Committee believe that the current economic recovery has set the stage for achieving a generation of growth and expanding opportunity. Confidence in America's future and pride in its heritage has seldom been higher.

Our prescription for a generation of growth is to strengthen our trust in our free enterprise economic system and to adhere to a general policy guideline of reducing Federal spending, taxation, and regulation, and promoting greater private-sector savings, investment, and self-reliance. The role of government is to facilitate and stimulate change—not manage or plan it—and assist when necessary in the transitional dislocation associated with change.

The failure of the government in managing change is perhaps nowhere more evident than with respect to agricultural policy. Counterproductive farm programs have seriously jeopardized the international competitiveness of America's farmers, contributing significantly to the present stress within the agricultural and rural communities.

The 99th Congress must focus its attention on the continuing problems of budget and trade deficits, high real interest rates, inadequate levels of personal saving, and erratic and indiscernible monetary policy.

DEMOCRATIC VIEWS

“Building for the Future: A Strong and Competitive America”

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RECOMMENDATIONS

Recommendation No. 1

The Administration should provide more aggressive leadership in demanding that the trade agreements between the United States and its trade partners are followed in a fair and equitable manner. The Administration must be much more aggressive in seeking to reduce artificial export subsidies and many practices which unfairly exclude American products from foreign markets. The growing division between the executive and legislative branches over unfair trade practices is weakening our ability to resolve differences with our trading partners. It is further increasing the prospect of a protectionist response that could be damaging to all parties. But we should realize that most of our trade problems are made in America. That leads to Recommendation No. 2.

Recommendation No. 2

The current mix of fiscal and monetary policy should be reversed in order to better promote productivity, higher employment, and growth without renewed inflation. It is making mincemeat of our ability to compete in world markets and is dooming many Americans to long spells of unemployment. The highly stimulative fiscal policy and relatively restrictive monetary policy now being pursued are keeping interest rates high, the dollar overvalued, and important sectors of our economy at recession levels. It is distorting investment and threatens to cripple our emerging high-technology industries where many jobs of the future must come. It is creating unnecessary agony in our agricultural and manufacturing sectors resulting in lost employment opportunities. The primary means of reversing the mix is by cutting the Federal deficit.

Recommendation No. 3

Analysis contained in this report clearly establishes that, other than interest on the debt, virtually all real growth in Federal spending has been in the area of defense and foreign affairs. It is beyond the purview of this Committee to determine if the threats posed by our adversaries, and the foreign policy objectives of this government, require the level of defense spending which has been requested in the Administration's FY 1986 budget.

It is the firm responsibility of this Committee, however, to state that, if the Congress determines that increased spending in this or any other area is necessary, the bill should be paid now rather than later. To delay simply adds unnecessarily to future tax burdens and contributes to an intergenerational transfer of resources that is unfair and threatens our future standard of living.[1]

Recommendation No. 4

Major changes in fiscal year policy should be made now while the recovery is still strong and before more damage is inflicted on key industrial sectors.

Recommendation No. 5

The Congress should adopt a tax reform and simplification package. That package should seek to ensure that taxpayers with similar incomes and financial circumstances pay similar total tax bills. The net result should be that the individual income tax bears a smaller share of the total tax burden. The package should make tax treatment between various types of business more nearly equal. It should keep or expand provisions which have proven effective in stimulating savings and investment and eliminate those which were aimed at that goal but have failed to produce savings commensurate with revenue losses.

Recommendation No. 6

In a time of severe budgetary limitations, tough choices need to be made. In making those choices, we need to reach a proper balance between today's needs and tomorrow's investments. But, the portion of the Federal budget that provides direct investments in the future has been virtually cut in half since 1980. Further attempts to reduce spending should not target the overall level of investment in the Federal budget. That portion of the budget should be reviewed to obtain maximum return from available dollars. But drastic reductions in the only part of the budget that provides for public investment initiatives threaten our long-term competitive edge. Deep additional cuts in the overall total for investment are simply another form of borrowing against the future, and should be avoided. Congress should, for analytical purposes, establish a budget category of investment expenditures for annual review in the budget process.

Recommendation No. 7

The Federal Government should play an active role in promoting excellence in education. Efforts already underway at the State and local level for improving school effectiveness should be assisted by the Federal Government. A variety of local needs can best be met with resources organized on a national level. Federal efforts which have contributed to improving student performance nationwide in the early grades should now be directed at the junior and senior high school levels.[2]

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[1] Senator Proxmire states, "The magnitude of the deficit makes it imperative that the defense budget be limited in growth to a level consistent with our national security needs. Objective evidence argues that eliminating unneeded weapons systems like the MX and the B-1B by ending cost-plus procurement, by slamming shut the revolving door that has so closely tied defense contractors and defense officials, and by eliminating excessive civilian and top-heavy military officials, this country could swiftly and decisively increase its military capability with little or no increase in military appropriations."

[2] Senator Proxmire states, "The proper place for the control and financing of education must remain with parents, students, and State and local governments. The Federal role should emphasize the provision of supplemental aid for the disadvantaged and handicapped."

Recommendation No. 8

Failure to establish a more equitable system of direct payments or indirect tax deductions impedes equity, public confidence in needed and germane social programs, and our capacity to adapt to needed economic change. It is possible to fiercely defend social programs for the middle class and the needy without compulsively defending the status quo. The Congress should conduct a comprehensive review of the techniques by which government provides services, direct payments, and indirect tax subsidies to promote housing, health care, child care, nutrition, job skill development, and income maintenance to targeted population groups. Federal assistance in those and related areas needs to be made more rational, equitable, and cost effective, and must serve to foster better employment opportunities. The review should explore ways to better link resources with needs.

Recommendation No. 9

Liberals must pay more attention to business values and conservatives must pay greater attention to civic values. The argument between those two cultures is intellectually interesting but economically debilitating and is of little value in building America's future.

SUMMARY

1984 was a year of rapid growth and low inflation. Most indicators point to continued growth and low inflation in 1985, although growth in 1985 is expected to remain below 1984's 6.8 percent rate. Inflation also is expected to remain in the 4 percent range, well below the levels throughout much of the 1970's.

But some important sectors of the economy are not participating in this recovery. Several major types of manufacturing and most of American agriculture have not seen a significant upturn since the bottom of the recession. More than 7 percent of the work force remains unemployed.

Despite good short-term prospects for continued recovery, threats to longer term growth are becoming increasingly apparent.

TRADE

America's trade problems go beyond the dollar's overvaluation. Close to half of our $123 billion trade deficit in 1984 was caused by the overvalued dollar. But the remainder was still much larger than any trade deficit in history prior to 1981. Part of that results from our inability to boost productivity as rapidly as many of our competitors. Another reason is unfair trade barriers. Bilateral trade with Japan accounts for more than 25 percent of our total trade deficit. Testimony before the Committee documented a variety of unfair barriers presently in use by the Japanese. Such restraints to U.S. products in Japan cost this country an estimated $12 billion in sales and approximately 400,000 jobs in 1984. But testimony also makes clear that, even with the unacceptable practices of some of our trading partners, the largest share of our trade problem is homegrown.

OVERPRICED DOLLAR

Overseas borrowing and the resulting 30 to 40 percent overvaluation of the dollar have helped to temporarily hold down inflation and keep interest rates from going even higher. But overvaluation is having a devastating impact on large and important segments of the economy. Most types of manufacturing engaged in exporting or in competition with imports are losing sales. Profits in these industries have dropped and many businesses that, under ordinary circumstances, would be profitable are facing serious financial difficulties.

This is affecting investment patterns in a way that will weaken the Nation's economic strength and reduce future employment opportunities. Of particular concern is the impact which overvaluation is having on our most competitive industries and those which would otherwise have the greatest opportunities for growth and the creation of new jobs.

Overvaluation is the direct result of the large net inflow of foreign capital into the United States. A major factor in that net inflow is interest rates in the United States. They are higher than those in the rest of the world because of the present level of Federal borrowing. Also contributing to the inflows are the lack of investment opportunities overseas and the current foreign investment confidence in the U.S. economy relative to other economies.

Continued willingness by foreign investors to lend here will mean ongoing difficulty for agriculture and manufacturing because such capital flows will affect the dollar and the price of American products in foreign markets. If, on the other hand, foreign investors decide to lend less in the United States, it could drive up interest rates and rekindle inflation.

In short, the trade and budget deficits have left us in a no-win situation. They have created an addiction to foreign capital that either will lead us to high interest rates and inflation, if our supply is interrupted, or continue what appears to have become a misguided industrial policy in reverse that could eventually price our exporters out of business.

FEDERAL DEFICIT

The spectacular growth in the Federal deficit during the past four years has resulted in an even more spectacular growth in the interest needed to service the national debt—from $53 billion in 1980 to more than $130 billion by 1985. The rising interest burden could potentially cause the Federal deficit to explode. About two-thirds of Treasury borrowing this year goes to pay debt interest. As interest payments continue to increase, we have to borrow more each year just to cover interest costs. Each year's deficit adds to the following year's interest costs and thereby increases the following year's deficit, a cycle that in the end might be stopped only by extreme actions, such as the creation of massive inflation to lower the real value of the debt. The best way to prevent the deficit from becoming a runaway problem is to reduce it now.

PATTERNS OF FEDERAL SPENDING

Federal spending has continued to grow despite the deficit problem. Two budget areas have increased much faster than the inflation rate. Outlays for military and foreign affairs have grown from $145 billion in 1980 to $268 billion this year. They would increase to $303 billion in 1986 under the Administration's request. Interest spending to service the public debt has grown even faster in percentage terms. Federal retirement and disability spending has grown with the rate of inflation and with the over-65 population. Programs for the non-elderly poor have grown slightly faster than the rate of inflation, but much slower than the 25 percent increase in the number of non-elderly persons living in poverty.

The one category that has experienced significant cuts is the "everything else" portion of the budget, which has been slashed in real terms by $25 billion between 1980 and 1985 and would be cut by an additional $34 billion in real dollars in the President's 1986 budget. That everything else portion consists primarily of two types of programs: one keeps the Government running on a day-to-day basis, such as the courts, the Federal Bureau of investigation (FBI), Immigration and Naturalization Service, and the Treasury Department; the other is the investment portion of the budget. It includes investments to train people, to educate people, to defeat disease—everything that includes investment in the basic tools of economic growth (highways, sewage treatment plants, soil conservation, and the like).

As a percentage of total spending, the investment portion of the budget has been cut almost in half. It will have declined from 21 percent of Federal outlays in 1980 to 11 percent in 1986 if the President's budget proposal is adopted. Defense will have increased from 25 percent to 31 percent and interest on the debt will have increased from 9 percent of nearly 15 percent. Support for the elderly, the poor, and the disabled will have declined slightly as a percentage of the total.

INVESTING IN YOUTH

Government investment is important to our economic future in a variety of areas. While education remains the primary responsibility of State and local government, the Federal Government should assist local schools in their efforts to improve instructional quality. Despite reports by a variety of national panels on school quality, Federal support of schools has dropped in real dollar terms. Federal programs directed specifically at raising the quality of our schools remain a tiny portion of total Federal educational spending.

Quality maintenance is also a problem facing higher education. Questions about course and graduation requirements need to be addressed. There is also a need to match degree offerings with the economy's needs for various types of skills.

INVESTING IN WORKERS

Most of the job of training the work force, outside of the traditional educational system, falls to the private sector. Because of our economy's nature, however, the private sector has failed to reach some workers in some industrial sectors, some geographical areas, and certain groups in the labor force, including the long-term unemployed and displaced workers. They are not being reached by any attempt to provide basic skills or to upgrade or modernize their capabilities. In addition, at present, there are only limited efforts to provide jobs to the long-term unemployed.

INVESTING IN PHYSICAL INFRASTRUCTURE

Our investment in physical capital is lagging in much the same way as our investment in human capital. Bridges, roads, and water and sewer systems are wearing out. They are neither being rehabilitated nor replaced fast enough to meet demands placed upon them. In some areas of the country, economic growth may well be constrained in the future because the infrastructure cannot support expansion. Our real per capita expenditure on infrastructure declined by 40 percent between 1965 and 1984.

INVESTING IN BASIC RESEARCH

Research is an important factor in the creation of new industries and the stimulation of economic growth. We cannot afford an erosion of government support of basic science research and development for civilian purposes. Two-thirds of all basic research is currently funded by the Federal Government.

TAX INVESTMENT

Government also plays a role in stimulating private investment. One way is by providing a climate conducive to investment—maintaining stable conditions and encouraging sustained periods of growth. Another is through specific investment incentives in the Tax Code. These incentives, however, must effectively stimulate investments that lead to economic growth if they are to offset the loss in revenues and potential increases in the deficit which they otherwise create.

WORKING TOGETHER: GROWTH WITH EQUITY

Probably no factor threatens our long-run growth more than our inability to agree on national goals or to work together to achieve those goals. One major impediment to developing effective economic policies is the almost theological debate between those who would achieve economic growth and those who would emphasize economic equity. Those are not irreconcilable goals. They are, in fact, inseparable in a democratic society with deeply held religious values and a belief in a strong work ethic. Certainly, the first order of business is providing a strategy that will generate strong growth, since without growth there is no new wealth to share. Yet growth alone is not enough.

Equity is the glue that binds a democratic society together. There must be widespread agreement that the benefits and the responsibilities are distributed fairly within society. A society as wealthy, as talented, and as imaginative as ours should be able to devise a strategy that both promotes equity and builds a better environment for growth if we make choices on the basis of what works rather than on the basis of economic ideology. In many areas, however, policies of the Federal Government are not equitable and are not effectively disciplined to promote essential growth.

Tax burdens fall unevenly on industries and on families, with many large corporations paying no tax despite high profits, and families with the same incomes paying widely differing amounts of tax.

The government subsidizes housing for middle-income and upper income Americans through the Tax Code and for the very poor through public housing, but middle-income and low-income families who cannot afford to buy a home get no direct help.

The elderly on Medicare have access to quality medical care as do workers with good tax-deductible, employer-paid medical benefits. The poor with no assets qualify for Medicaid. But for those without insurance and for the unemployed, there is little help. Similar inequities exist in food and nutritional programs, unemployment insurance, and welfare.

The continuing level of Federal deficits is creating serious issues of generational equity. We are witnessing the largest intergenerational debt transfer in history.

There are strong reasons for those interested in growth and in equity to work together. First, without growth, it will be impossible to improve equity, because the disadvantaged are unlikely to get a bigger share of any pie that is not growing. Second, there are ways to stimulate growth that also improve equity, such as through programs that improve training and cushion the ill effects of needed economic change. A recognition of our common interests can lead to better solutions, better communications, and better cooperation.

This is an economic and social imperative.

Chapter I. A YEAR OF RAPID GROWTH, LOW INFLATION, AND CHANGE

THE ECONOMY IN 1984

In 1984, the American economy experienced strong expansion of output and employment, continuing a trend that began in 1983. The economy grew 6.8 percent in 1984, one of the largest gains in three decades.[1] In the fourth quarter, the economy grew at a moderate pace, suggesting expansion will continue. The preliminary estimate of 1.3 percent growth in the first quarter indicates that growth has slowed, but many economists expect somewhat more rapid growth in the quarters ahead.

During the first nine quarters of the recovery, the economy grew at an average rate of 5.5 percent, comparable to the average postwar expansion (though below the growth in the 1970–1973 and 1975–1977 recoveries).

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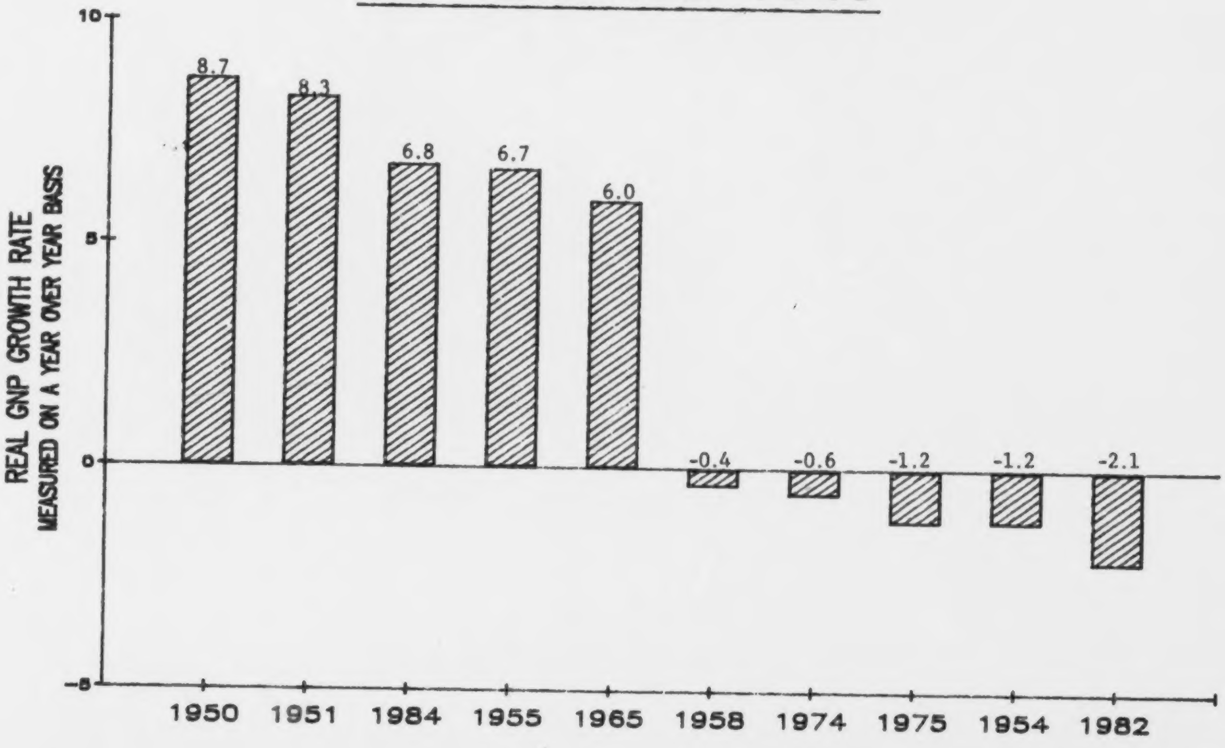
[1] Measured on a year-over-year basis, last year was the strongest since 1951; on a fourth-quarter-to-fourth-quarter basis, five years since 1951 (including 1983) have shown more rapid growth than 1984.

ILLUSTRATION 1

FIVE STRONGEST AND FIVE WEAKEST YEARS SINCE 1949



SOURCE: DEPARTMENT OF COMMERCE

The present recovery is impressive by most measures. In 1984, civilian employment grew by more than three million and the unemployment rate declined from 8.2 percent in December 1983 to 7.2 percent in June 1984. Since the middle of 1984, however, the unemployment rate has stagnated at a high level by historical standards. Industrial production has risen 5.6 percent, but capacity utilization remains at a low level of 81 percent.

Corporate profits have risen significantly for a wide variety of industries, and new investment in plant and equipment has grown at the highest rate since the mid-1960's. Some industries considered deeply troubled a few years ago, such as auto manufacturing, also have prospered. Personal consumption expenditures in 1984 were 5.3 percent above the level in 1983, the fastest gain since 1976. Average real weekly earnings rose for the second consecutive year.

Despite the pace of the recovery, inflation—as measured by the Consumer Price Index (CPI)—has not risen above the 4 percent level. This, more than any other factor, provides hope that the recovery will continue through the remainder of 1985. A variety of factors has contributed to the overall moderation in the pace of inflation, including a decline in world oil prices, lower mortgage interest rates, lower food prices, declining wage expectations, and a rise in the dollar that held down import prices. It should be understood that some of the very factors which account for the decline could quickly change, producing upward pressures on inflation tomorrow in contrast to the downward pressures they produced yesterday.

An example is that the drop in energy prices accounts for nearly 50 percent of the decline in the overall rate of inflation during the past five years. The worldwide recession of 1981–1982 significantly cut oil consumption, as did various energy conservation steps taken since the mid-1970's by governments, corporations, and private consumers. Decreased demand was balanced against a growing production capacity and a continued need for oil, gas, and coal revenues by exporting nations. The combination of those factors has resulted in a steady decline in the cost of energy. Energy costs in America (accounting for 11.5 percent of the CPI) remained constant in 1984, as compared to annual increases as high as 37 percent in 1979.

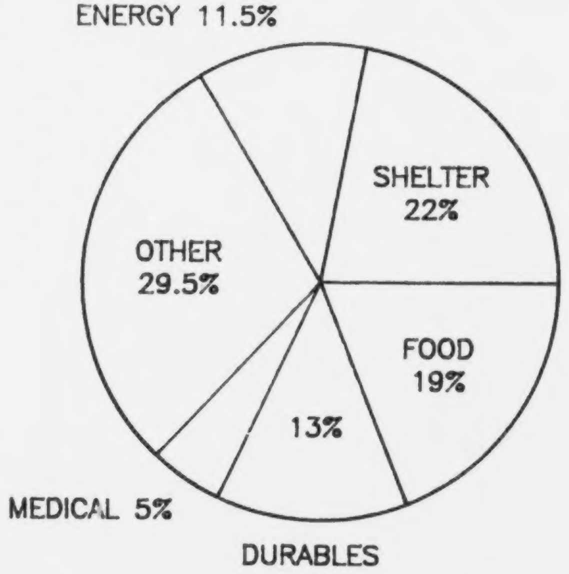
Home mortgage rates, which drove up the cost of housing in the late 1970's, remained high throughout 1984. Despite that, the fact that no further increases occurred held the overall rise in shelter costs (22 percent of the CPI) to about 4 percent.

The American consumer benefited in 1984 from a year of good growing weather in farm States, and from the fact that the value of the dollar drastically cut foreign demand for our agricultural products. This held food prices (19 percent of the CPI) to an increase of less than 4 percent last year. The spectacular rise in the value of the dollar, which continued throughout 1984 and into 1985, has cut the cost of imports (accounting for 11.5 percent of all goods and services purchased by Americans in 1984) in this country. It also has held down prices on many domestically manufactured goods that compete against imports. It is estimated that the dollar was overvalued against world currencies by 30 to 40 percent during 1984. That means prices of imported goods were as much as one-fourth lower than they would have been had the dollar not been overvalued.

Perhaps the most important structural change in the economy relative to inflation was the fact that wage expectations remained low during 1984 despite the strength of the recovery. While there is no definitive answer as to why workers were willing to accept less than might ordinarily be expected, several explanations account for most of the moderation in wage demands:

ILLUSTRATION 2

COMPONENTS OF CONSUMER PRICE INDEX



SOURCE: BUREAU OF LABOR STATISTICS

(1) The fear of job loss resulting from the severity of the 1981-1982 recession has made many workers willing to accept real wage reductions in hope of keeping their jobs. This trend has been accentuated by an increasing awareness of the potential impact of foreign competition on a variety of industries.

(2) The level of unemployment has remained extraordinarily high compared with other recoveries.

(3) The greater stability during the 1982-1984 period in the prices of energy, food, and housing has given workers greater confidence in the long-term purchasing power of their paychecks.

In summary, the largest contributor to the decline in inflation, as measured by the CPI, over the last five years has been the elimination of inflation in the energy area. The next most important factors have been the decelerations in food and shelter prices. If prices in those three areas had risen as rapidly last year as they did five years ago, the CPI would have increased at a rate of more than 12 percent, well above the actual rise of 4 percent. The rise in the value of the dollar has led to significant reductions in the prices of imports and import-competing goods (not directly measured in the CPI). These developments have brought welcome relief on the inflation front, but future trends in each area may not be as favorable.

There is a broad, though not unanimous, agreement among economic forecasters that inflation will remain low during 1985. A significant chance exists that energy prices will drop further, perhaps dramatically. If the value of the dollar remains high, the prices of food and imports will remain about the same. The battle against inflation, however, is not over and must not be abandoned.

UNEVEN PROGRESS

While the Nation as a whole has benefited from recent growth and low inflation, certain segments of the population, and major sectors of the economy—expecially our agricultural and manufacturing base—are caught in a serious crunch and there are some long-term clouds on the horizon. Part of that crunch is a natural result of economic change which is reshaping the nature of the American economy.

But the problem goes beyond that. The problem is being exacerbated by the inflated dollar and by the inconsistencies in tax policies which are squeezing out various sectors and contain the seeds for serious long-term problems. Our Tax Code promotes investment but it also produces some inefficiency and wasted investment, including a glut of office construction and an overinvestment in pecan groves.

Agriculture.—American agriculture remains severely depressed. Many farm communities have suffered recession conditions for more than five years. In much of rural America, small- and medium-sized farms are struggling to survive. As high interest rates continue to push up production costs, excess supplies of milk, wheat, corn, soybeans, and other key commodities have held prices down. With weak economic conditions in much of the world and with the high value of the dollar limiting export markets, increasing numbers of farmers are finding it impossible to make a living.

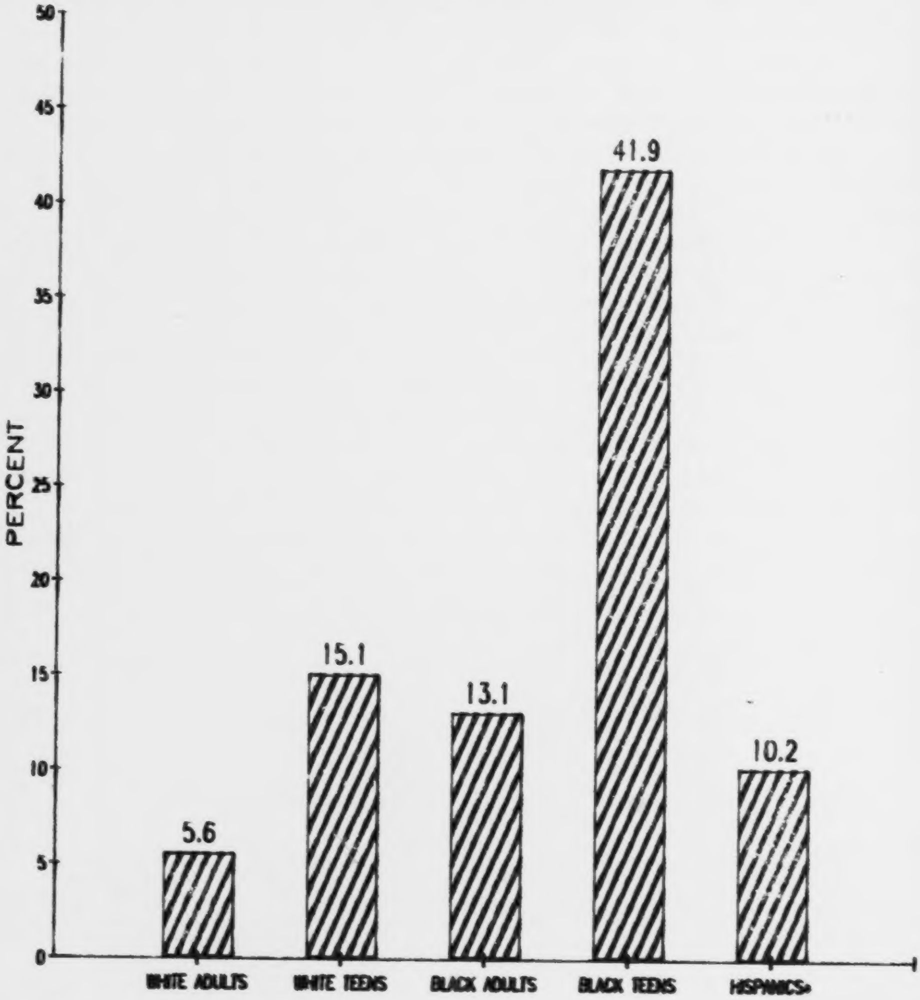
Bankruptcies, which normally affect only a small fraction of American farms, have risen sharply. The U.S. Department of Agriculture reports that, of the 697,000 family-sized farms, 43,000 (with 10 percent of the total farm debt) is insolvent and unlikely to last another year. Another 50,000 (with 11 percent of the debt) are in only slightly better condition. A final group of 136,000 farms (with 26 percent of the debt) is unable to meet their principal payments. Farm bankruptcies have been particularly hard on younger farmers who were willing to take risks in order to expand their productive capacity. Many farmers' current circumstances result more from an inability to anticipate the Government's fiscal and monetary policies and their impact on interest and exchange rates than from inefficiency or mismanagement.

Many rural areas are in a poor position to weather current economic strains, because suppliers, service establishments, and banks are highly dependent on the health of the farm economy. Twenty-six rural banks failed during 1984, and another 288 are considered financially shaky by Federal regulators.

Minority Groups.—Minority and low-income households have also lagged behind as the economy has improved. Unemployment among blacks, which reached 21 percent during the recession, was still 15.2 percent in March 1985, compared to 6.2 percent for whites. Historically, black unemployment has been approximately twice that of whites. During the last several years, blacks have experienced unemployment close to 2.3 times the level experienced by whites.

ILLUSTRATION 3

UNEMPLOYMENT RATES: VARIOUS DEMOGRAPHIC GROUPS
MARCH 1985



SOURCE: BUREAU OF LABOR STATISTICS

* Breakdown not provided by BLS for Hispanic age groups.

Besides having higher rates of unemployment, minority workers have experienced longer spells of joblessness. They are more likely to be underemployed and more likely to drop out of the labor force. More than 30 percent of those counted as discouraged workers (those who want to work but are not counted as unemployed because they have given up looking for jobs) are black.

A variety of factors contribute to the higher rates of unemployment and longer periods of joblessness for blacks. Lack of adequate skills training and education are particularly important. In 1983, the high school drop-out rate for white students was 26 percent, whereas the drop-out rate for blacks was 43 percent. Clearly, discrimination in the work place has also contributed to differential unemployment rates among blacks and whites.

The problem of widespread idleness among minority youth continues to be very serious despite the general economic improvement. Over 43 percent of black teenagers who both wanted jobs and were actively seeking them remained jobless in March. Less than one out of every four black teenagers actually held a job.

The job market for Hispanics is somewhat brighter than for blacks, but considerably worse than for non-Hispanics; the unemployment rate among Hispanics in March was 10.2 percent, or well above the 5.9 percent rate for non-Hispanic whites.

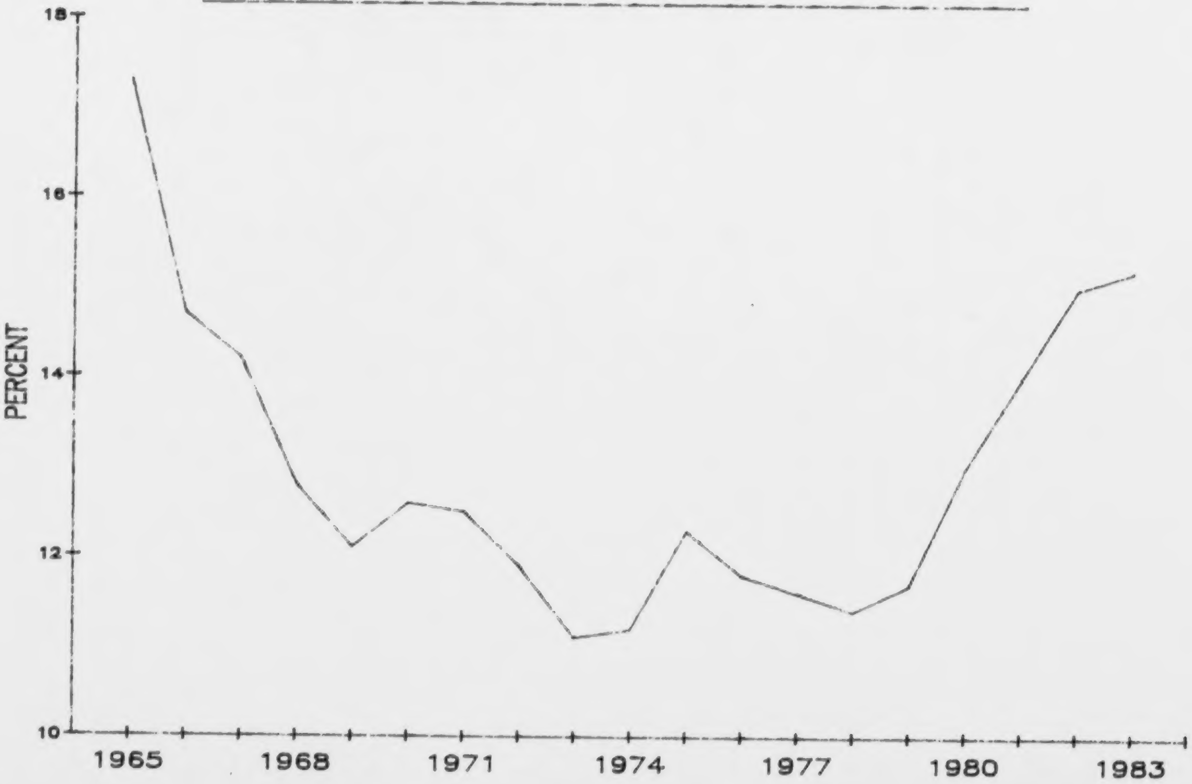
Increased Poverty.—The poverty rate has increased sharply in the past few years, and the latest data (for 1983) indicate that the first year of the recovery failed to bring it down. High unemployment has caused some of the additions to the poverty population by reducing job opportunities and earnings. In 1983, the poverty rate was 15.2 percent, and there were 35.3 million poor—10.8 million more than in 1978. Virtually all of the increase was concentrated in the non-elderly population. The poverty rate in 1983 was 35.7 percent among blacks and 28.4 percent among Hispanics

The Congressional Research Service (CRS) estimates that, in 1984—based on traditional relationships between economic indicators—the poverty rate fell to about 14 percent. However, the range for this estimate is plus or minus 1.1 percent. Because this range is very broad, and the actual poverty rate will not be announced until the summer of 1985, caution must be used in interpreting these estimates.

Using slightly different assumptions, but essentially the same model, the Institute for Research on Poverty estimates the 1984 poverty rate will be 14.5 percent. If the actual number lies between the CRS and the Institute for Research on Poverty estimates, it will mean that 24 months of recovery have still left 33 million Americans living in poverty—an increase of 4 million over 1980. Attacking that problem is not just a moral requirement. It is a key to promoting economic growth. Moving these people into decent jobs adds to purchasing power, stimulates demand, creates jobs, and helps eliminate a long-term drain on the economy.

ILLUSTRATION 4

THE POVERTY RATE, 1965–83



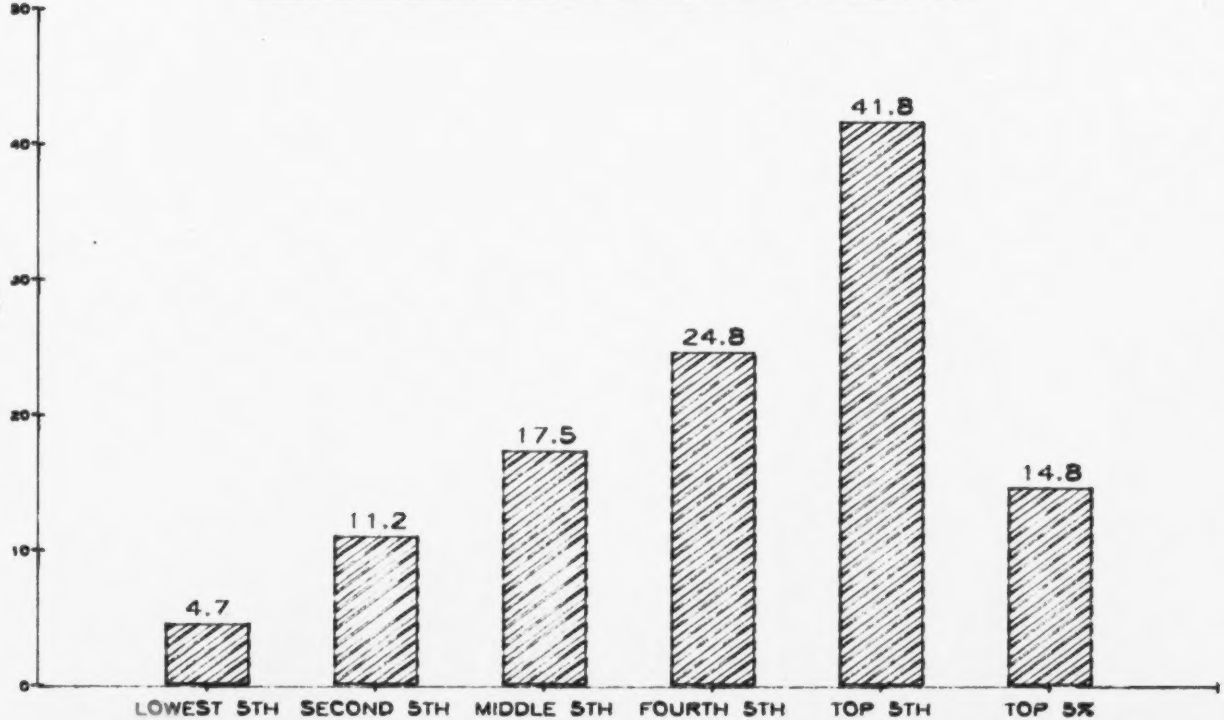
SOURCE: BUREAU OF THE CENSUS

In addition to continuing poor prospects for employment, many low-income households have been adversely affected by changes in eligibility requirements and reductions in benefit levels in a variety of income maintenance programs.

These trends in poverty have taken place in an economy with sizable disparities in income, and even greater differences in wealth, as shown in Illustrations 5 and 6. In 1982, the top 20 percent of the population received 41.8 percent of after-tax income, more than eight times the share of the lowest fifth. And the top 5 percent received more than three times as much as the bottom 20 percent. While the eight-to-one disparity is large, it is far smaller than the disparity in the division of wealth. In 1972, the top 1 percent held 26 percent, and the top 0.5 percent held 20.5 percent. Given tax and budget changes since that time, it is doubtful that this group has suffered any significant erosion in its share of either wealth or income. And a substantial body of opinion believes that the evidence indicates they have, in fact, enhanced their position.

ILLUSTRATION 5

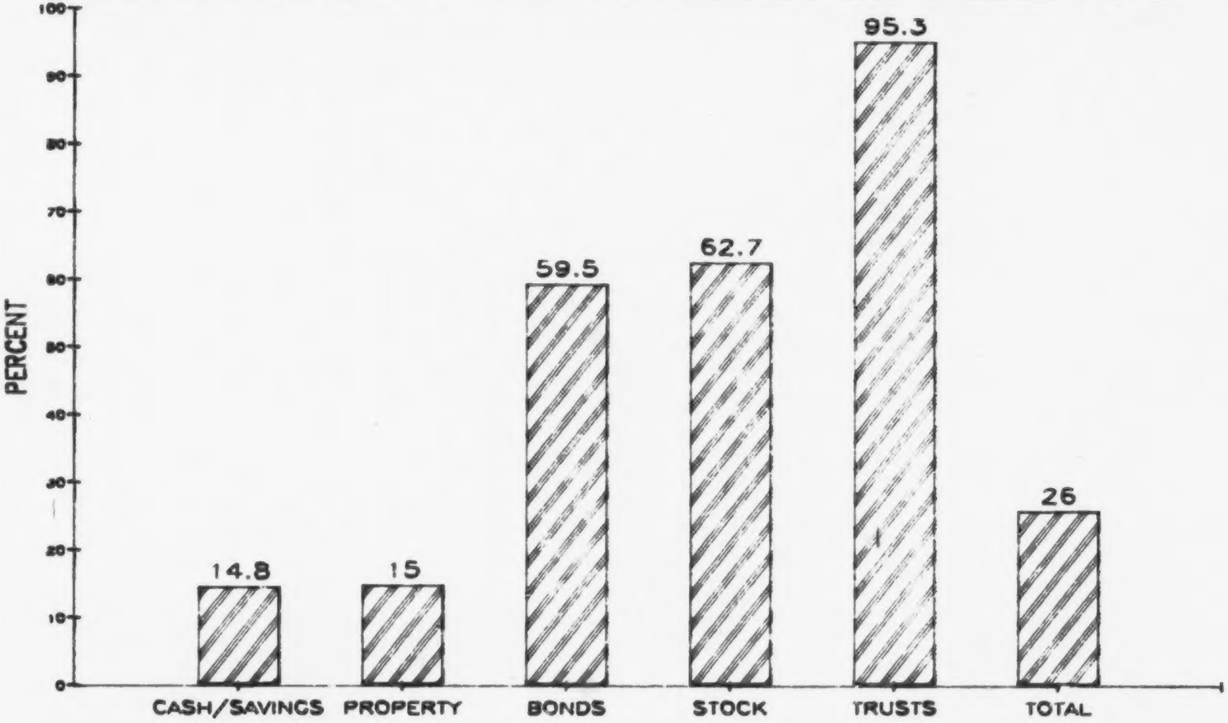
THE DISTRIBUTION OF AFTER-TAX INCOME, 1982



SOURCE: BUREAU OF THE CENSUS

ILLUSTRATION 6

PERCENTAGE OF WEALTH HELD BY THE TOP 1% OF THE POPULATION, 1972*



SOURCE: BUREAU OF THE CENSUS

* Most recent year for which data are available.

While lower inflation has been helpful to all income groups, cutbacks in government benefit programs have fallen most heavily on low-income people. This is particularly true among the "working poor" with incomes just above the poverty line. Program changes may have contributed to the rise in poverty.

Displaced Workers.—Growth rates in this recovery have differed considerably among industries. While the service sector has expanded rapidly, manufacturing has regained only about three-fourths of the jobs lost during the recession. Employment in the steel industry continued to fall the last two years, and industries like textiles, chemicals, and machinery have added workers very slowly. There is a continuing reduction in employment in certain other goods-producing industries, including mining, petroleum products, and leather.

Many of the workers who have lost jobs in goods-producing industries have found their old skills of little value in finding new employment. According to a Bureau of Labor Statistics (BLS) survey conducted in January 1984, over 5.1 million workers lost long-term jobs during the previous five years, usually because of plant closings. Forty percent—or two million of these workers—did not get new jobs.

Older displaced workers face the bleakest reemployment prospects. Nearly 60 percent of those over 55 have failed to find other jobs. Unemployment rates are also much higher for black and Hispanic displaced workers than for whites.

Steel, autos, machinery, and other durable goods industries have accounted for about one-half of all displaced workers. Compared with others who lost manufacturing jobs, steelworkers have had particularly low rates of reemployment. In most industries, higher skilled workers, including professionals and managers, were the first to find new jobs.

Forty percent of all displaced workers live in eight States whose economies are dominated by heavy industry—New York, New Jersey, Pennsylvania, Michigan, Ohio, Illinois, Indiana, and Wisconsin. They generally endure much longer spells of unemployment and are more likely to exhaust their unemployment insurance benefits than workers elsewhere.

It is not uncommon for displaced workers to take new jobs offering fewer hours, lower pay, or reduced benefits than their previous ones. About 45 percent of the displaced workers who have found jobs earn less than they did before. For manufacturing workers, pay cuts amounted to at least 20 percent. Nearly one-fourth of the reemployed have not regained health insurance coverage they had lost when their previous jobs were eliminated.

Chapter II. LONG-TERM THREATS

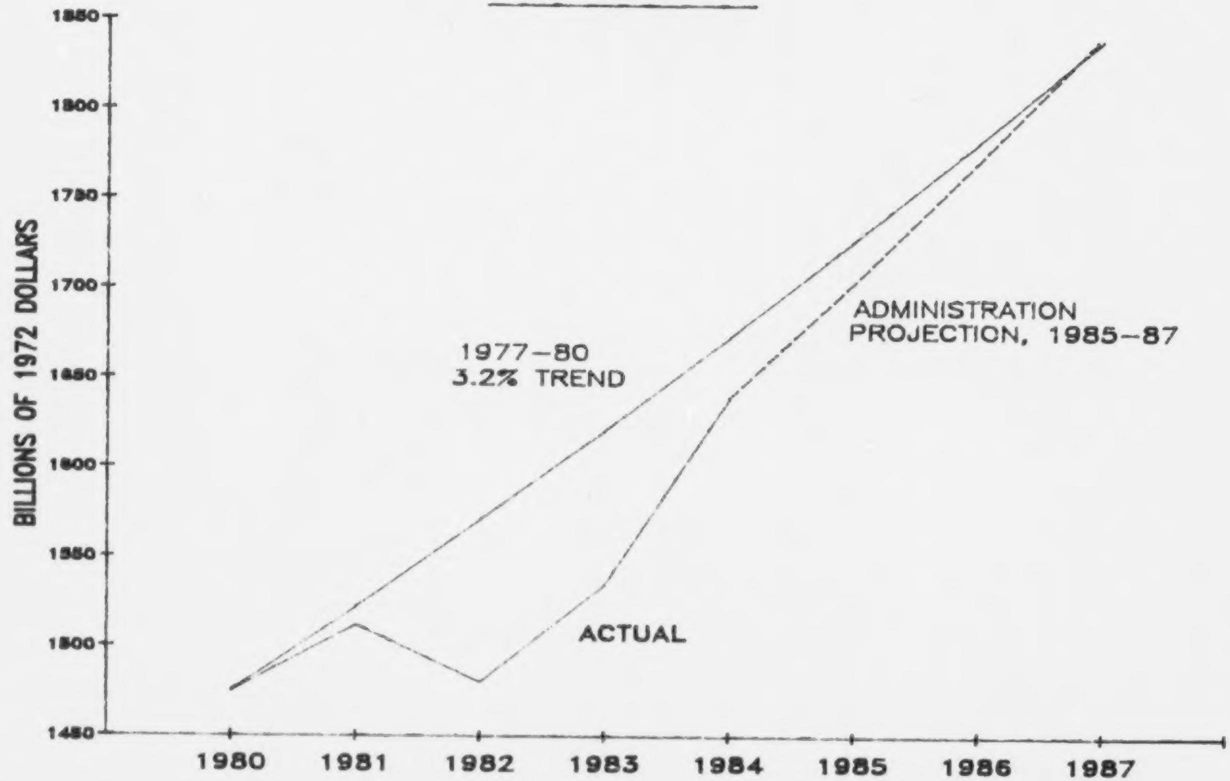
We need to break the "boom and bust" economic cycle of recent years and provide for sustained periods of more even growth. While the last 28 months have been very good ones, they only partially offset the effects of the 1981-1982 recession.

For the 1981-1984 period as a whole, growth averaged only 2.7 percent a year, below the previous four-year average (1977-1980) of 3.2 percent. Under the economic projections made by the Administration in this year's budget, it will take until the end of 1988 to reach the level of real gross national product (GNP) that would have been obtained with a steady 3.2 percent growth rate from 1981 through 1988.

Testimony before the Committee indicates five threats to sustained recovery. They are (1) the possibility of rising interest rates, (2) the danger of renewed inflation, (3) the trade deficit, (4) overseas borrowing and the overvalued dollar, and (5) the Federal deficit. They are addressed below.

ILLUSTRATION 7

REAL GNP



SOURCE: JOINT ECONOMIC COMMITTEE

RISING INTEREST RATES

Interest rates have remained high yet relatively steady the last two years. The Federal Reserve has attempted to offset a very expansionary fiscal policy with a relatively tight monetary policy. The target for growth in the money supply for 1985 (as measured by M1) has been set for a range of between 4 and 7 percent. That compares with the target range of 4 to 8 percent that was set by the Federal Reserve for the growth of M1 in 1984, meaning the Fed currently plans to be somewhat more restrictive in 1985 than it was in 1984, when M1 grew by 5.2 percent.

While restricting or expanding the supply of money has a major impact on interest rates, the confidence of foreign lenders in the strength and stability of the U.S. economy is a factor of rapidly growing importance and one of which the Federal Reserve will be forced to take notice. If a more expansionary monetary policy decreases the confidence of foreign lenders in U.S. economic stability, interest rates could in fact be forced upward.

As Chairman Volcker recently indicated before the Committee:

> * * * confidence is a necessary ingredient in any effort to see lower interest rates in the years ahead, and it is also essential to maintain the flow of capital from abroad, upon which we are for the time being dependent * * *. The dilemma is that so long as demands on our own capital markets exceed our capacity to save, the stability of our own markets is, in effect, hostage to the large continuing inflow of foreign capital.

While Chairman Volcker's discussion primarily was in regard to lowering interest rates from current levels, the same considerations obviously would apply to efforts to prevent interest rates from going higher. If the erosion of confidence of foreign lenders in the U.S. economy results in a decreased inflow of capital, interest rates would rise. If the Fed attempts to counter that rise by an expansion in the money supply, it could, using Chairman Volcker's logic, accelerate the decline in confidence and push interest rates still higher.

That means a major role in determining the rise in interest rates will have been left in foreign hands in a way that compromises the use of traditional tools for responding to and correcting upward pressure on interest rates.

The least painful and most effective way of reducing our dependence on foreign capital is to reduce the Federal deficit. With a firm deficit reduction plan in place, the monetary authorities will have more flexibility to lower interest rates and support economic growth.

THE THREAT OF RENEWED INFLATION

Americans are greatly relieved by the recent moderation in prices following a decade of rapid inflation. Despite a good short-term picture for low inflation, we face the possibility of significant upward pressure on prices at some point in 1986 or possibly even before.

As stated earlier, the rise in the value of the dollar contributes significantly to holding down increases in the CPI. The long-term impact, however, may only be to delay and perhaps even exacerbate inflation rather than lower it.

The 53 percent increase in the value of the dollar against other world currencies since 1980 has lowered the price of some imports as much as 35 percent.

The price of many domestically manufactured goods has also been affected because 80 percent compete against imports. Domestic producers in a variety of areas shaved profit margins to the bone hoping to hang on to a portion of their market until exchange rates push the price of foreign products back up. They will be anxious for a profit-making opportunity as soon as exchange rates permit.

Agriculture is an example of an area where short-term gains against inflation may be more than offset by long-term losses. In some instances, foreign buyers have stopped purchasing certain commodities because they simply cannot afford those items at the inflated prices which exchange rates have produced. Buyers of other commodities such as wheat have turned to lower cost, foreign suppliers.

One estimate indicates that last year alone the climb of the dollar against world currencies shaved the inflation rate from 5.5 percent to 4 percent, or a reduction of nearly 30 percent.

After the oil shocks of 1973 and 1979, we should be all too familiar with the potential inflationary impact that our continuing dependence on foreign oil can have at almost any moment as the result of events far from our shores and largely beyond our control. The threat of renewed inflation is real because many of the events which led to the decline in inflation were beyond the control of government and appear to be cyclical in nature. The inflated value of the dollar may have served simply to delay price increases temporarily rather than having any lasting positive impact on the root causes of inflation.

THE TRADE DEFICIT

The overvalued dollar accounted for somewhere between one-half and two-thirds of the $123 billion trade deficit in 1984, according to testimony before the Committee. Even if the higher (two-thirds) estimate is used, the remaining portion of the deficit is larger than any trade deficit in our history other than 1983.

The portion of the trade deficit attributable to factors other than overvaluation of the dollar also costs the U.S. economy in terms of lost employment opportunities and unused productive capacity.

That portion can be attributed to a variety of problems which must not be overlooked. One is that the United States over a long period of time has not been able to increase productivity as fast as it has increased in most other countries. That means American products have become relatively more expensive and less competitive. This problem will be discussed in some detail later in the report.

Economic Weakness Abroad.—A second problem which has depressed demand for U.S. goods overseas is the continuing economic turmoil in many lesser developed countries. Their debt problems force major decreases in the amount of goods and services they can purchase from the developed world and the United States in particular.

From 1981 to 1984, the U.S. trade deficit with the six major high-debt Latin American countries deteriorated by $21.5 billion—from a $5.4 billion surplus to a U.S. deficit of $16.1 billion. The U.S. trade balance with developing countries as a whole deteriorated by $34 billion from 1982 to 1984. U.S. exports to the developing world fell by $9 billion during the period, while U.S. imports from the developing world increased by $25.3 billion. Unless the debt problems of the developing countries are resolved, this important market for U.S. goods will remain depressed.

The continuing weakness of the economic recovery in Europe also has lowered the total overseas demand for American products.

Moreover, it is becoming increasingly apparent that American exports and potential exports are not being treated fairly in many foreign markets.

Foreign Barriers to Trade.—Developing countries have a variety of barriers to U.S. exports, particularly in the high-technology and services areas. The European Community protects certain sectors of its economy. But nearly one-third of the total U.S. trade deficit stemmed from a bilateral imbalance with one country, Japan, which represents only 10 percent of world GNP.

In 1984, Japan sold $60.4 billion in the United States while U.S. sales to Japan totaled only $23.6 billion—a $36.8 billion bilateral trade deficit, almost twice our trade deficit with any other country. Despite constant negotiations between the two governments and promises of liberalization by the Japanese, U.S. exports to that country actually have declined in real dollar terms since 1980 while imports from Japan more than doubled. The Commerce Department now estimates that unfair Japanese trade barriers account for $12 billion of the total bilateral deficit. That amounts to nearly 400,000 lost American jobs.

The Japanese demonstrate considerable ingenuity in the variety of trade barriers used against U.S. exports.

The most easily identified Japanese barriers are tariffs and quotas. Although the average Japanese tariff rate is 3 percent, the lowest in the industrial world, Japan maintains high tariffs in excess of 20 percent on a number of agricultural and manufactured goods of significant export interest to the United States.

For example, the Japanese maintain high tariff rates on forest products, leather, chocolate, fish, fabricated aluminum, and whiskey. In addition, they have import quotas on some 20 major American products including citrus, beef, and leather goods.

Because of the nature of the Japanese economy, it is often quite easy to prevent the sale of American products in Japan in a variety of ways without using formal barriers. These barriers are generally difficult to identify and even more difficult to reduce through negotiations.

In the United States and Europe, foreign companies generally have the opportunity to participate in the drafting of standards for products and technical regulations. But Japanese Government ministries tend to rely on domestic industry associations to develop the tests and standards that products must meet. These standards, set without foreign participation, are designed more easily to favor domestic over foreign products. Although Japan made a commitment in May 1982 to permit foreign input in standards drafting, the commitment so far has remained unfulfilled.

Japan also maintains border customs procedures that can be severe impediments to foreign goods entering Japanese markets. Goods are denied entry or subjected to delays for trivial documentation errors, classified improperly under categories that have higher tariffs, and valued at inflated prices.

"Buy Japan" procurement policies are another major impediment to selling manufactured goods in Japan. The Nippon Telegraph and Telephone Corporation (NTT), despite prolonged and difficult negotiations, has failed to increase significantly the amount of purchases it makes from U.S. telecommunications firms. It remains to be seen whether, under the new policy of dismantling NTT, American firms will benefit or continue to be locked out.

Japanese national industrial policies limit foreign competition while nurturing key domestic industries targeted for major export growth. The U.S. semiconductor industry's experience is a case in point.

In a report prepared for the Joint Economic Committee, the Semiconductor Industry Association documents the frustrations and futility of trying to penetrate the Japanese market. The Japanese outsold American-made semiconductors nine to one in Japan, while the United States outsold the Japanese four to one in Europe and three to two in other overseas markets.

These figures are clear evidence of barriers to the Japanese market. The semiconductor industry states Japanese barriers "are the most formidable that U.S. industry faces in any major world market."

A particularly telling section of the semiconductor industry's report is the description of U.S. sales in the Japanese market during a period of significant yen appreciation. Between 1978 and 1980, the yen appreciated 44 percent against the dollar. Yet, the U.S. share of the Japanese market was only marginally affected. The share rose briefly to 14 percent in 1979, then returned to the 10 or 11 percent level. Those who argue that our bilateral deficit with Japan is strictly a function of the overvalued dollar should examine closely the experience of the semiconductor industry.

Today, as was the case a decade ago, U.S. semiconductor sales largely are limited to products the Japanese do not make themselves, or make in limited amounts. Briefly, in 1983, U.S. sales in the Japanese market increased significantly from one quarter to the next. The increase occurred during a worldwide boom in semiconductor sales. Supply was tight in Japan and, as a consequence, consumers turned to American products. However, by late 1984, semiconductors were abundantly available from Japanese producers, and the sales of U.S. firms dropped sharply.

The costs of Japanese protectionism to the U.S. economy are large. The Semiconductor Industry Association estimates that, were U.S. sales in the Japanese market commensurate with levels elsewhere in the world, an additional 27,000 jobs would be created, along with increased revenue for research and development (R&D) and capital investment.

The costs, in terms of the future competitiveness of the U.S. semiconductor industry, are even greater. As long as the Japanese domestic semiconductor industry is protected from foreign competition, the industry has the luxury of building capacity which can be used to support sales in export markets at very favorable prices. This has happened in the past and each successive episode inflicts severe damage on the U.S. semiconductor industry's share of world sales. The Japanese are adding semiconductor production capacity at a rate suggesting they believe they can dominate the world industry by the end of this decade, continuing to add to the bilateral trade deficit.

Despite negotiations, entreaties, and a series of pronouncements, the Administration has failed to make measurable progress in reducing trade barriers. Worse, in the midst of a major shift in Japanese policy governing foreign access to the telecommunications industry, the Administration unilaterally decided not to request a renewal of the voluntary restraint agreement governing Japanese auto exports. This one-sided approach to free trade does not suggest the firmness of purpose needed to open the Japanese market or to build a lasting structure of free trade.

The growing division between the executive and legislative branches over unfair trade practices is weakening our ability to resolve differences with our trading partners. It is further increasing the prospect of a protectionist response that could be damaging to all parties.

The pattern of abuse by trading partners is clear and increasingly well documented. But no matter what problems America faces because of conditions abroad, our biggest trade problems are homegrown.

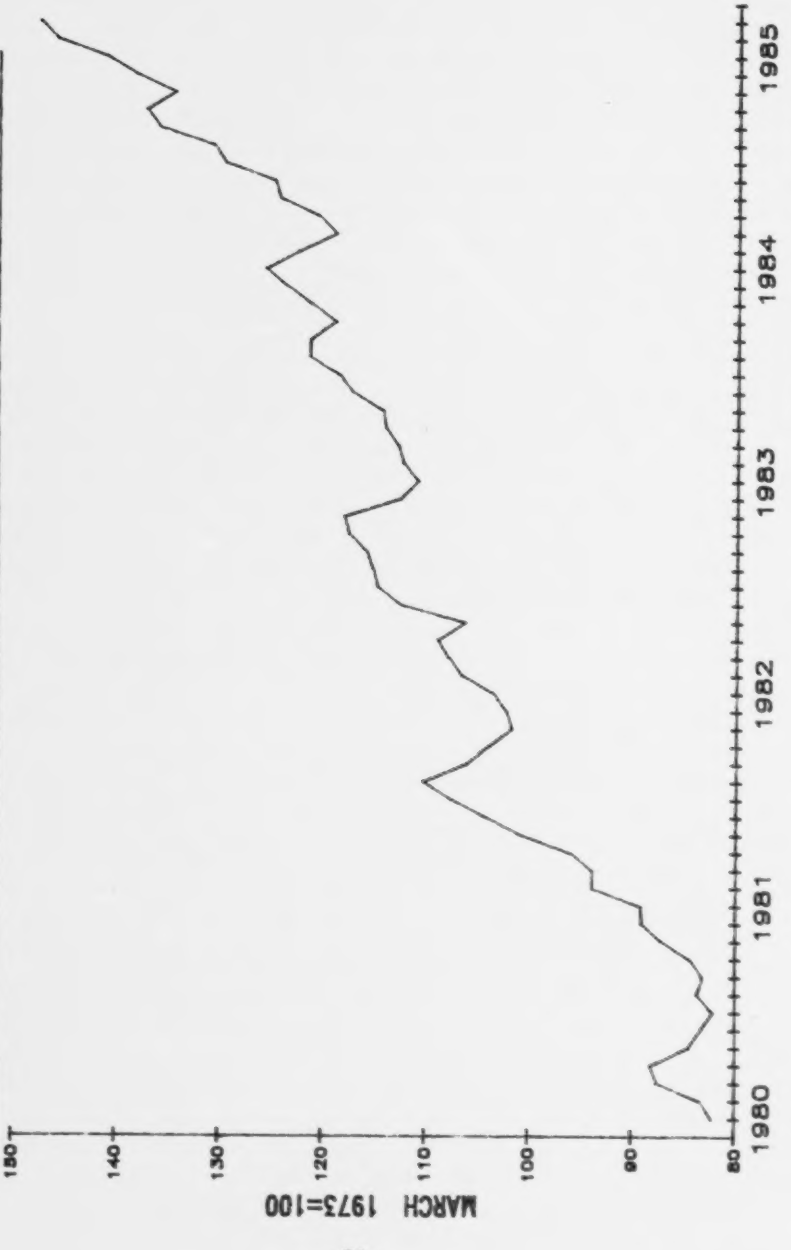
OVERSEAS BORROWING AND THE OVERVALUED DOLLAR

A nation's ability to maintain a positive balance of trade traditionally has been believed to be the primary factor in determining the relative value of its currency. Today, however, we face a unique situation in which the United States continues to run enormous trade deficits while the value of the dollar has risen steadily against foreign currencies.

Between the summer of 1980 and early 1985, the dollar increased in value by about 53 percent against all other currencies despite the fact that the total trade deficit during that period was approximately $290 billion. Against the currencies of certain trading partners, the dollar has appreciated even more rapidly. From July 1980 to March 1985, the increase against the British pound was 122 percent, against the West German mark 93 percent, and against the Japanese yen 18.5 percent.

ILLUSTRATION 8

EXCHANGE VALUE OF THE DOLLAR, CPI ADJUSTED



SOURCE: FEDERAL RESERVE BOARD

This apparent anomaly is explained by the fact that the trade deficit is being offset by tremendous inflows of foreign investment capital. During 1984, more than $89.8 billion in foreign capital came into the United States as compared with only $12.6 billion in U.S. capital that went overseas. That $77.2 billion surplus in capital flow to the United States compares with a $33.4 billion deficit in 1980.

The net inflow of such amounts of capital is a new event in this century which affects our economy in numerous ways:

- It directly or indirectly has financed a major portion of our Federal debt.
- It has, as a result, increased the pool of capital available to private borrowers in this country. This is critical to both private investment and consumer borrowing since both would be crowded out by Federal borrowing in the absence of foreign inflows. Federal borrowing represented 67 percent of net private savings in 1984.
- It has kept the high real interest rates in the United States from going even higher.
- It has sent the value of the dollar skyrocketing—providing consumers in the United States with bargains on foreign products but playing havoc with U.S. exporters.
- It has adversely affected the capital investment and modernization of the third world and most of our European trading partners.

The reasons behind this large net flow of capital into the United States are not well understood despite its immense impact on both the U.S. and world economies. One explanation is the current lack of strong investment opportunities in most overseas markets. Another is the high level of confidence foreign investors place in the strength of the U.S. economy.

But the most frequent explanation, and one heavily supported by testimony before the Committee, is the higher rates of return paid in the United States as a result of the upward pressure on U.S. interest rates from Federal borrowing.

Because Federal debt is expected to increase at a rapid pace over the next several years (as reflected in the President's FY 1986 budget request), the United States will become increasingly dependent on foreign lenders. It is not likely, however, that those lenders will be able or willing to meet our demand for funds indefinitely. Whether the inflows are stemmed by an improvement in the European economy, declining confidence in the U.S. economy, or the exhaustion of foreign capital resources available for investment in the United States, it is virtually certain that this will slow significantly at some future date. Whether it comes to a crashing halt or a gradual decline is an open question.

As demands for domestic borrowing begin to exceed foreign willingness or ability to lend in the United States, interest rates could rise, consumer borrowing and private investment could be choked off, and the recovery could sputter.

But our dependence on foreign capital is doing serious damage even in the absence of a threatened interruption in supply.

Data Resources, Inc. (DRI), in a study recently prepared for the Joint Economic Committee, warns that the dollar's appreciation "is driving a massive wedge between domestic and foreign production costs." DRI estimates that the appreciation of the dollar already has cost the United States nearly two million jobs in the import-competing sector of the economy and has held industrial growth 9 percent below what it otherwise would have been. According to the study:

> The Nation will pay a significant price for these aberrations in our economic development. Our national capital formation has been retarded and misallocated, implying heavy future costs in lost productivity. Equally important, much of the net investment which has occurred has been financed by foreign capital which will be owed at an exceptionally high return unless the United States unexpectedly returns to double digit inflation. This does imply a lower U.S. standard of living.

As brought out in other testimony, the overvalued dollar hits hardest at some of our most efficient and competitive producers. Farmers and manufacturers, who in ordinary times can ship products overseas and sell at or below the prices charged by foreign competitors, are being crunched by a 30 percent to 40 percent price disadvantage.

The damage caused by overvaluation will not be repaired easily after the dollar falls, according to the DRI study. The study states:

> By changing relative costs, the dollar's strength is motivating undesirable structural transformations in the U.S. economy. Expecting the dollar to remain overvalued, manufacturing companies are shifting production abroad and outsourcing, or purchasing components and finished products from foreign suppliers. Meanwhile, U.S. exporters are abandoning overseas markets where sales have been disappointing. Such changes are not easily reversed. Nor can a dollar correction fully reverse the penetration of imports in the U.S. market. Foreign companies are building distribution networks, gaining a foothold in the U.S. market. By increasing their export volume, foreign producers are achieving new economies of scale that will enhance their price advantage.

The current reliance on foreign capital allows the United States to engage in unprecedented Federal borrowing without paying the price of rising interest rates and higher inflation which most economists predicted. We have, however, placed ourselves in an increasingly precarious position which, in two ways, threatens the recovery in the short term and the overall health of the economy long term.

If the inflows continue at the current rate, or if they accelerate, expanding consumer demand in the United States may not result in increased domestic output. It may simply stimulate further imports. Recent BLS findings on the level of manufacturing employment indicate that this already appears to be happening. That inevitably would mean that income would fall and consumer demand would drop.

If the inflows slow, credit may tighten, interest rates may rise, the dollar may drop, and there may be upward pressure on prices.

Equally troubling are the more long-range implications that the current overseas borrowing level and the overvalued dollar have on investment patterns and on the health of key sectors of the economy.

There is considerable opposition in the United States to any government involvement in strategic economic planning because such involvement would necessarily place government in the role of picking winning and losing industries. Nonetheless, government is currently playing such a role by pursuing fiscal and monetary policies that create an environment in which winners are rapidly being turned into losers.

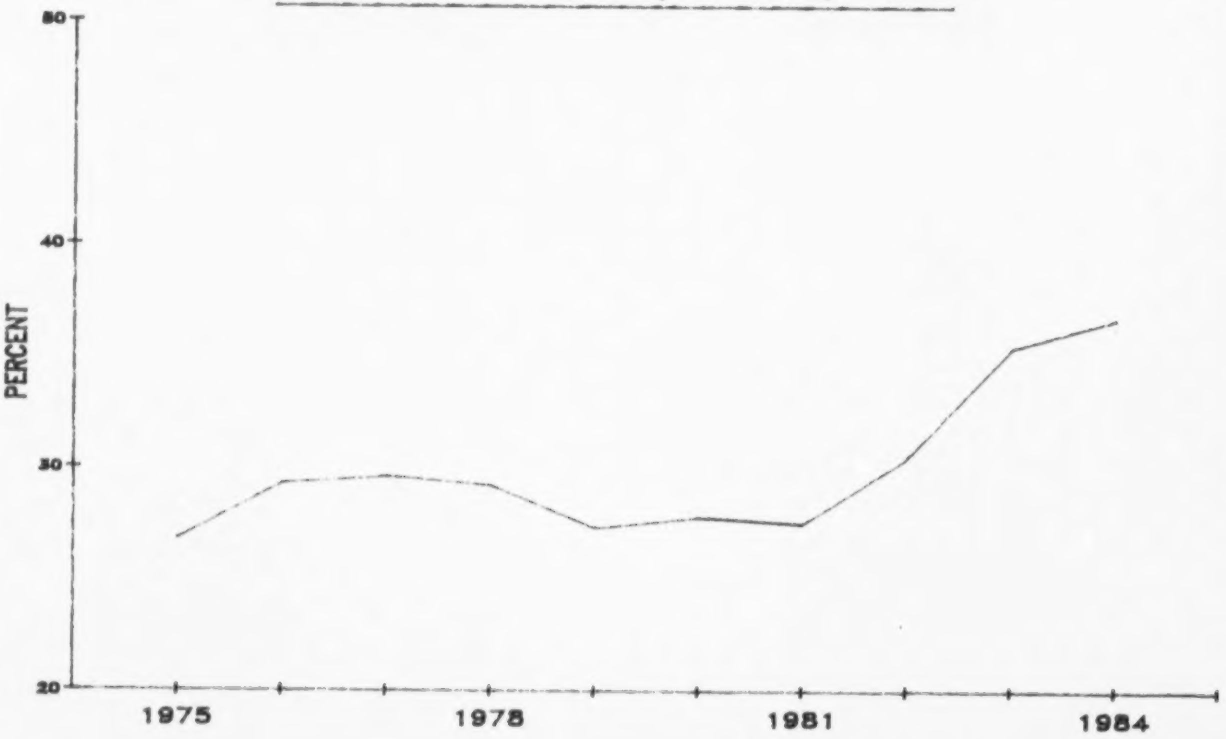
THE FEDERAL DEFICIT

The deficit proposed by the President for FY 1986 is $180 billion. During the current year, the deficit is expected to exceed $200 billion. These deficit projections are based on expectations of strong economic growth and declining interest rates.

By the end of FY 1985, the public debt will exceed $1.8 trillion, or more than double what it was at the beginning of 1981. During that five-year period, public debt will have increased from slightly more than one-third of GNP to nearly one-half.

ILLUSTRATION 9

FEDERAL DEBT HELD BY THE PUBLIC AS % OF GNP, 1975--84



SOURCE: DEPARTMENT OF THE TREASURY

Deficits of this magnitude underlie a variety of economic problems facing the United States and world economies, all of which threaten the strength and viability of the recovery.

The spectacular growth of the Federal debt during the last four years has resulted in even more spectacular growth in the amount of interest the Federal Government must pay to service that debt, and debt service, in turn, has become the single largest contributor to the growth of deficits.

In FY 1979, interest on the Federal debt was $42.6 billion. By FY 1984, however, interest payments had ballooned to $111 billion and interest payments are expected to rise further to $130 billion for 1985. The President's budget predicts that interest on the debt will grow to $142.5 billion for FY 1986 and to $152.9 billion by FY 1987. These projections optimistically assume a strong and sustained period of economic growth and declining interest rates, and assume that Congress will pass 100 percent of the President's proposed cuts in domestic spending. Even under these assumptions, interest payments on the debt will grow faster than the economy and faster than entitlement programs or military spending.

Under less optimistic and more realistic assumptions, debt service grows at a far more rapid pace. If we continue to assume all of the President's budget cuts are adopted but use the Congressional Budget Office (CBO) projections for interest rates and economic growth, debt service will grow to $146 billion in FY 1986, $161 billion in FY 1987, and $212 billion in FY 1990. But, if interest rates rise above the levels projected by CBO, or if the economy experiences a severe recession with the Federal deficit growing rather than declining, debt service could well be over $250 billion by 1990.

The most worrisome danger from our rising interest burden is that the growth in interest payments will eventually cause the Federal deficit to "explode" upward. Right now, almost two-thirds of what the Treasury borrows each year go to pay interest on the Federal debt. The need to borrow in order to pay interest on the debt simply adds to the debt. Each year's deficit would add to the next year's interest costs and the next year's deficit in a never-ending cycle.

Some analysts looking at the problem point out that it is extremely important that revenues exceed the amount required to cover all outlays other than interest. The extent to which revenues exceed outlays other than interest is termed "the primary surplus" and is a measure of the margin we have in protecting ourselves from a deficit explosion.

Under current policies, the Federal Government is running just enough of a primary surplus to keep the Federal deficit at a fixed fraction of GNP—just around 5.4 percent. Even though interest on the national debt will grow from 3.1 percent of GNP in FY 1984 to 4.1 percent by FY 1990, under current tax and spending policies, the primary surplus in the budget is also growing—by just enough to keep the overall deficit a constant fraction of GNP. Under current policies, the deficit will not balloon upward, but it will not get any smaller either.

If we can increase the primary surplus, either by increases in revenue or by cuts in spending on programs other than interest, then the Federal deficit should decline as a fraction of GNP if the economy performs as projected. If all of the President's recommended spending cuts were enacted, CBO estimates that the deficit would decline to 3.4 percent of GNP by 1990 and presumably below that in the years beyond. Increased revenues would have the same effect on the path of the deficit.

But, if the economy were to experience a serious recession within the near future, there is a strong possibility that the conditions would be set for a skyrocketing Federal deficit. The deficit could climb as high as 9 percent of GNP by 1990, according to one set of figures developed by CBO. If economic conditions at any time make it impossible to run a primary surplus, then the annual growth in interest on the Federal debt could begin to grow faster than we could raise revenues or cut other spending, and the deficit would skyrocket. At that point, we would be left with totally unpalatable choices, including creating inflation that would increase nominal GNP faster than the debt and thus gradually reduce the debt as a fraction of GNP.

The best way to prevent the deficit from becoming a runaway problem is to reduce it now: first, the more and faster we reduce the deficit, the slower the Federal debt will grow. Interest will consume a declining rather than increasing fraction of the budget. More of our tax dollars then could go for services and less for interest.

Second, the current pattern of borrowing forces the Federal Reserve to be more restrictive in controlling the supply of money than would be necessary if the deficit were declining, which creates a constant upward pressure on interest rates.

Third, both short-term and long-term competitive advantages in foreign trade will be further threatened if we do not get our budget house in order. But we must get it in order in a way that enhances, not cripples, our ability to compete over the long haul.

CUTTING THE DEFICIT

It is the duty of other committees of the Congress to perform detailed analyses of the budget, to determine where specific cuts are to be made, and to determine how revenue should be raised. Therefore, our report is aimed at developing a better understanding of the context in which budget decisions must be made and, in broad terms, the nature of the budget choices before Congress.

Spending and revenue measures signed into law by the President at or before the beginning of the current fiscal year will result in outlays of $938.2 billion and revenues of $734.9 billion during FY 1985, based on CBO projections. If inflation and the increasing numbers of Americans reaching retirement age each year are taken into account, the same level of government activity will require $984 billion in outlays in the coming fiscal year. This compares with only $788 billion in expected revenues, leaving a deficit of $196 billion.

To counter this, the President proposed a $5 billion cut in spending on the non-elderly poor and a $34 billion cut in other areas of domestic spending. These cuts, however, will be offset by increases in debt servicing and defense/foreign affairs spending. The cost of servicing the Federal debt will grow by $7.6 billion above the inflation adjustment for debt service, and the President is asking Congress for $24.6 billion in real dollar growth in defense and foreign affairs spending.

Under the President's plan, outlays would rise $34 billion above 1985 levels in nominal terms and would total only $12.3 billion below 1985 levels when allowances are made for inflation and demographics.

If the spending levels requested by the President in this budget are divided into five general categories, and 1985 spending levels are compared with 1980, several important trends become apparent. The categories are:

1. Defense and foreign affairs. (This includes Office of Management and Budget [OMB] functional categories 050 and 150 with the exception of U.S. contributions to the International Monetary Fund and the Export-Import Bank, since both are primarily justified on the basis of their impact on the domestic economy.)
2. Elderly/disabled. (This includes all retirement, senior, and disability programs as well as the portion of Medicaid and food stamps which goes to those over the age of 65.)
3. Net interest on the debt.
4. Assistance to non-elderly poor. (This includes all Federal spending for the six entitlement and eight discretionary programs that provide income maintenance, medical care, housing, and nutrition to the poor, except those over the age of 65.)
5. Everything else in the Federal budget. (This includes everything from tax collection to the courts, education, cancer research, and highway construction.)

Defense and Foreign Affairs.—From 1980–1985, the defense and foreign affairs portion of the budget increased from $145 billion to $268 billion. It would reach $303 billion in 1986, as proposed. This category has increased from 25 percent of government spending in 1980 to 28.5 percent in 1985, and would reach 31 percent in 1986 under the President's budget proposal, an increase of 24 percent.

Elderly and Disabled Programs.—These programs increased from $217 billion in 1980 to $344 billion in 1985 and $367 billion in 1986. The percentage of the budget taken up by these programs declined slightly from 37.6 percent in 1980 to 37.2 percent in 1986. Outlays for these programs have increased for two reasons: (1) inflation, which accounts for $14 billion of the $23 billion increase in the category in 1986, and (2) the increasing numbers of elderly in the population, which account for the remaining $9 billion.

None of the growth in these programs since 1980 is attributable to increased benefits beyond cost-of-living adjustments. In fact, a variety of limitations on entitlements to the elderly has been adopted since 1980, cutting outlays in FY 1985 by $7.7 billion, $265 per person aged 62 or more.

The President proposes additional savings of $5 billion in this category of programs. If adopted, these savings would reduce outlays in 1986 to $362 billion.

Interest on the Debt.—This is the most rapidly growing portion of the budget. Between 1980 and 1985, net interest payments on the debt grew from $52.5 billion to $130 billion, or by nearly 150 percent. Based on a prediction of stable interest rates, net interest payments on the debt rise in FY 1986 to $146 billion, or 14.6 percent of the total budget.

Non-Elderly Poor.—Federal programs for support of the non-elderly poor will result in nearly $59 billion in outlays in FY 1985, or about 6.3 percent of the total budget. These programs totaled more than 7 percent of the budget in 1980.

Despite the declining share of the budget represented by these programs, outlays in this category have grown more rapidly than the rate of inflation. These increases occurred despite significant benefit cutbacks and decreased levels of service.

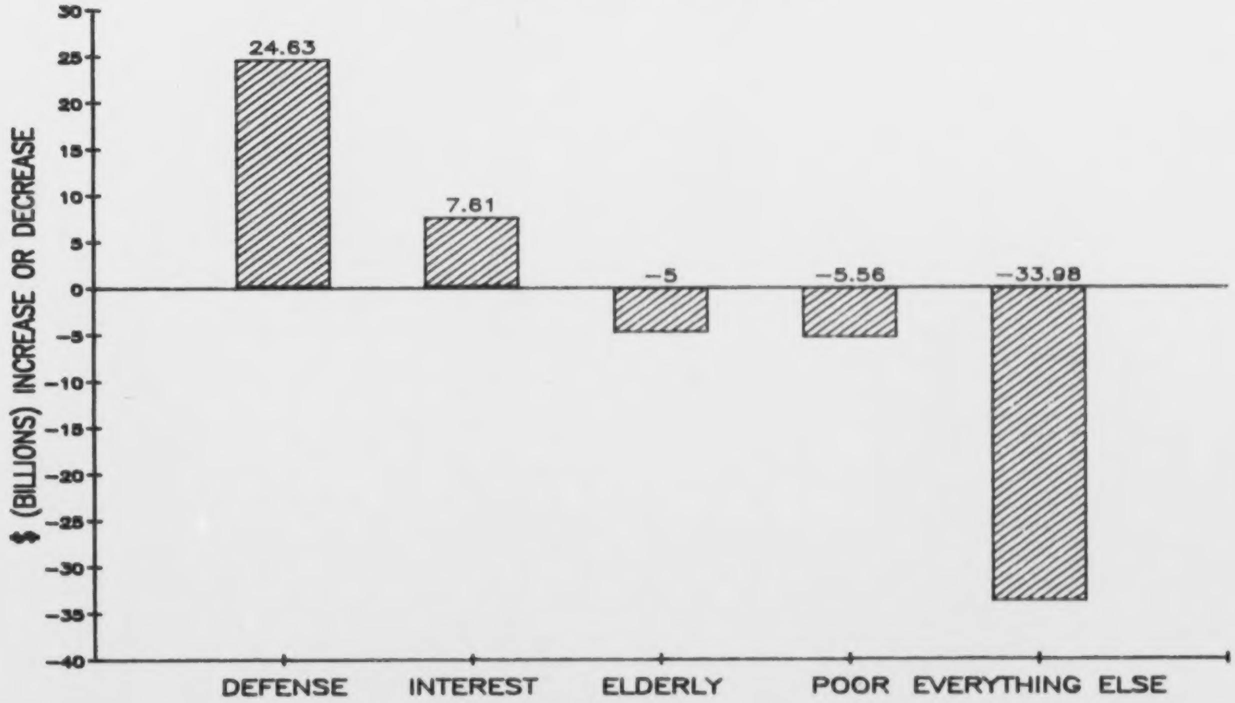
Important factors pushing up outlay levels in this category include:

1. The number of people below the age of 65 living in poverty increased by 6.1 million, or by 24.2 percent since 1980.
2. Because of the long period required to contract for and construct public housing, and the increased funding for that activity in the late 1970's, outlays in FY 1985 were more than $5 billion higher than in FY 1980.

For FY 1986, the President is requesting $5.4 billion in program cuts in this category, reducing total outlays to $55.7 billion, or 5.7 percent of the President's proposed budget.

ILLUSTRATION 10

'85+ INFLATION AND DEMOGRAPHICS VS. '86 REQUEST BY CATEGORY DOLLAR CHANGE



Everything Else.—The remaining portion of the Federal budget essentially contains two groups of expenditures. One keeps the Government running on a day-to-day basis. It pays for the Federal Bureau of Investigation (FBI), the courts, the Immigration and Naturalization Service, the Treasury Department—all of the day-to-day conduct of government's business.

The other portion of what is termed "everything else" in the budget is made up of everything government invests to train people, to educate people, to wage war against disease—everything that government does to clean up the water and air; everything that government does to build and maintain waterways, airports, and highways. In sum, it is everything that can be termed the investment portion of the budget—everything that government does to provide for a healthy foundation for all economic and human activity.

The President's budget would drastically shrink this "everything else" portion of the budget. In real dollars, this part of the budget has already absorbed a $25.8 billion reduction from 1980 levels. This category would be reduced by an additional $34 billion in real outlays under the President's FY 1986 budget. That would mean that the everything else portion of the budget would have been slashed from 21 percent of Federal outlays in 1980 to about 11 percent in 1986. America would truly be halfway to having a government whose only tasks are to defend the shores, deliver the mail, and write retirement checks.

The first trend that emerges is that growth as a percentage of overall Federal spending has occurred in only two categories: (1) the defense and foreign affairs category, and (2) interest on the debt.

Second, only one category of the budget has been cut in real dollars, the everything else category.

Third, the category that has been targeted for cuts is a small and rapidly shrinking portion of the Federal budget.

Because the President's FY 1986 budget leaves us with an unacceptably high level of deficit, debt, and Federal borrowing, the need to find spending cuts beyond those proposed in his 1986–1988 budget is obvious.

If those cuts are made based on the same mix of priorities represented in the budget trends described above, it is apparent that the category containing all activities of government, other than national defense, support of the elderly and disabled, and contributions toward the support of non-elderly poor, will be reduced by still larger amounts, further shrinking a portion of the budget that already, as a percentage of the total budget, has been cut almost in half since 1981.

The total elimination of this category is, of course, not practical. It includes numerous items such as tax collection, personnel management, and Federal litigation expenses that are necessary even if the government only provides for defense and retirement. Other items, such as law enforcement, immigration control, the courts, and the prison system, are essential to the maintenance of social order. Still other items are essential to economic order, such as air traffic control, the Coast Guard, and the maintenance of public lands and national forests.

But the biggest portion of the category labeled "everything else" is made up of programs that can be cut with little immediately noticeable consequence for the overall well-being of the economy. Reduced spending on highway and sewage treatment construction, energy research, job training, strategic petroleum reserves, education, health research, or soil conservation will ultimately have their major impact on society years, and even decades, after the cuts are made.

That is because these programs represent the investment portion of the Federal budget. Whether the Congress agrees to all of the cuts recommended by the President for this portion of the budget in the coming year, there are clear limits to the total amount of future cuts that can be imposed on the everything else category, if there is to continue any semblance of critically important investment activities in this country.

Illustration 11

BUDGET OUTLAYS BY CATEGORY
1980 ACTUAL

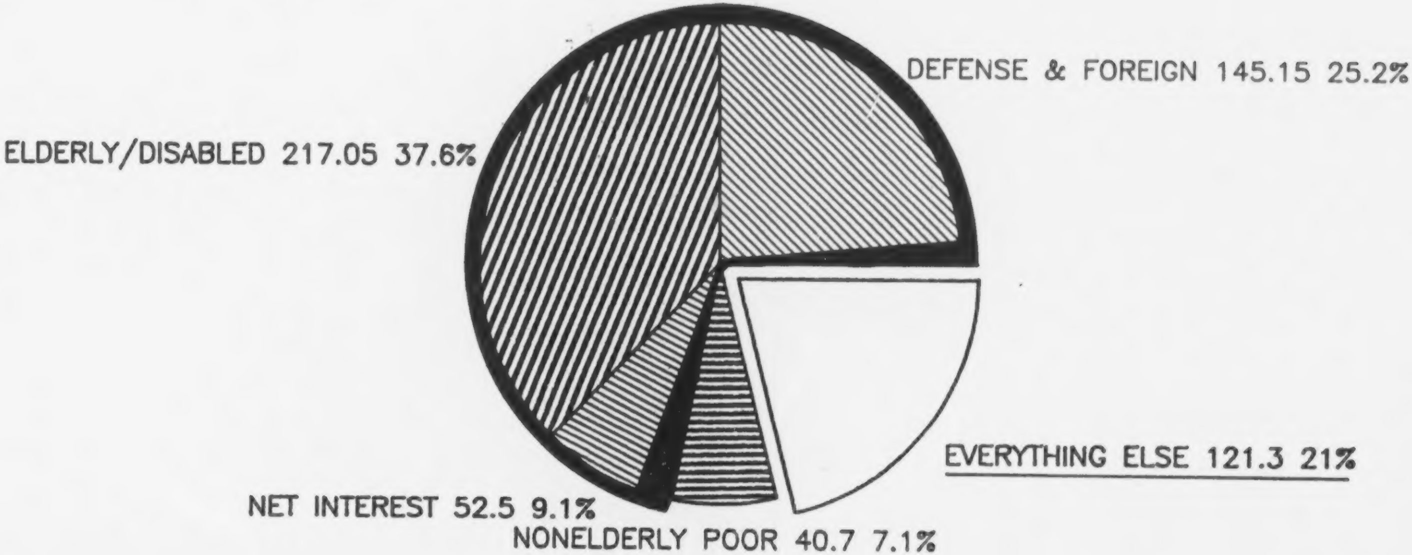


Illustration 12

BUDGET OUTLAYS BY CATEGORY
1985 ESTIMATED

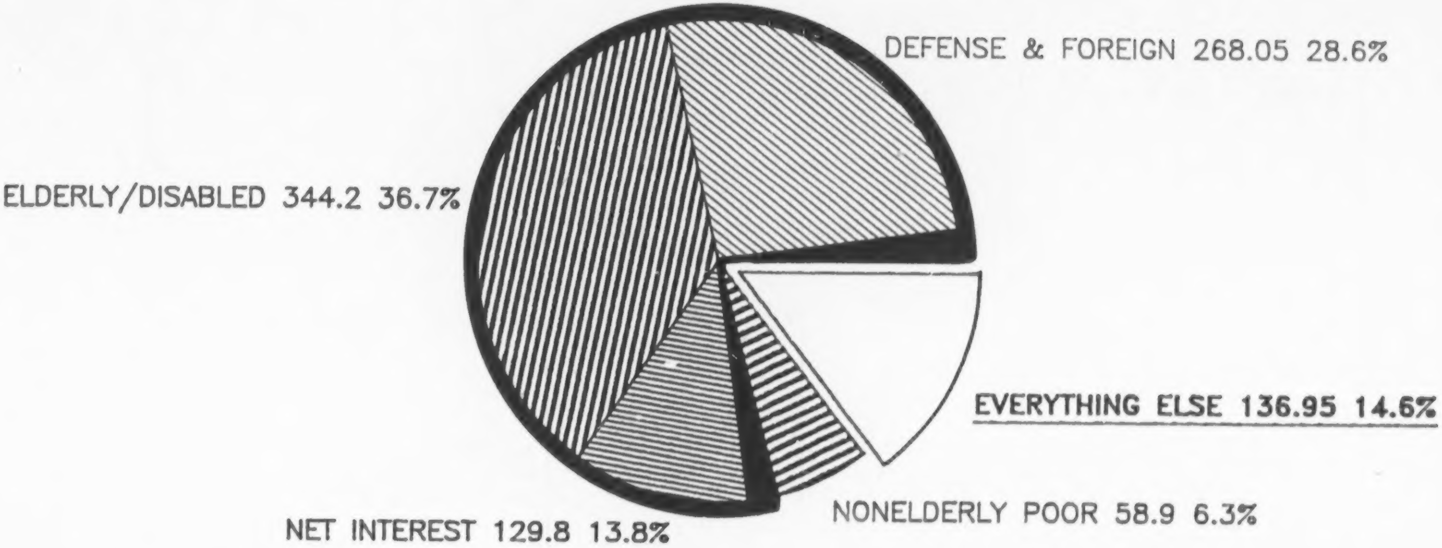


ILLUSTRATION 13

BUDGET OUTLAYS BY CATEGORY
1986 REQUEST

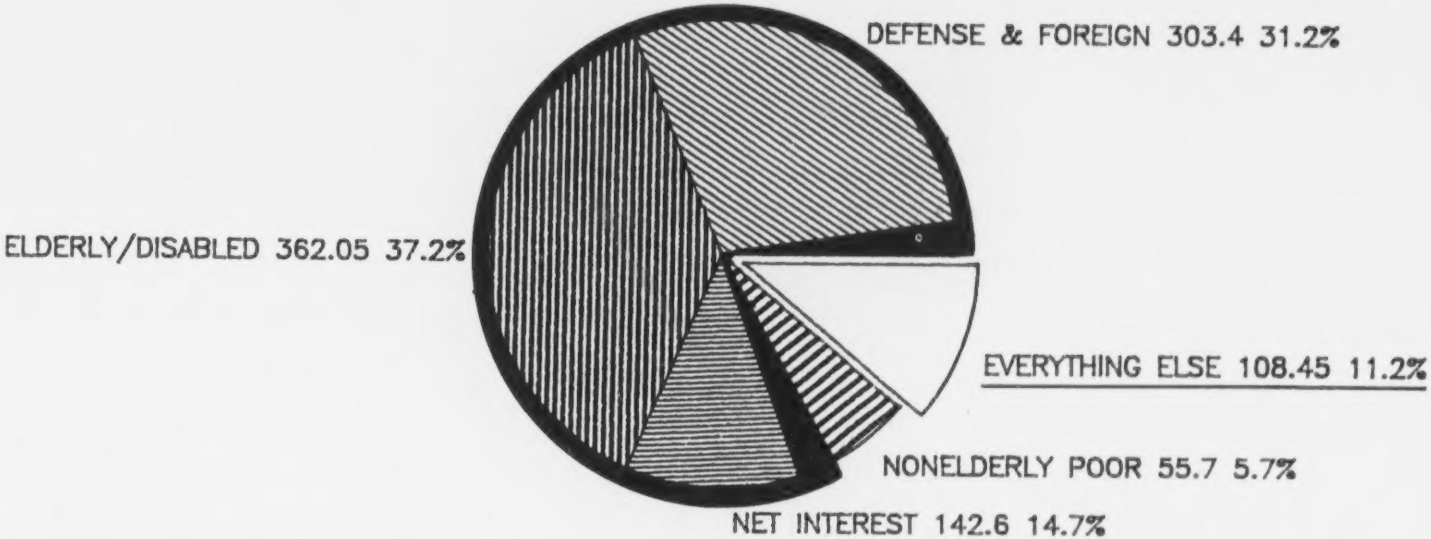


TABLE 1

BUDGET OUTLAYS BY JEC-REQUESTED CATEGORIES, 1980-1986

(Outlays in Billions)

	FY 1980	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986
	Actual	Actual	Actual	Actual	Actual	Current Policy	President's Request
Total Outlays	576.70	657.20	728.35	795.95	841.82	937.90	972.20
Total Revenues	517.10	599.25	617.75	600.55	666.45	734.90	793.70
Defense And International Affairs*	145.15	166.65	194.20	218.30	239.40	268.05	303.40
Elderly/Disabled	217.05	250.85	279.75	305.85	320.50	344.20	362.05
Net Interest	52.50	68.75	85.00	89.75	111.05	129.80	142.60
Non-Elderly Poor	40.70	44.25	43.45	50.25	53.00	58.90	55.70
Remaining Programs	121.30	126.70	125.95	131.80	117.87	136.95	108.45

* Defense and International Affairs differs from current policy in the following ways: (1) Export-Import Bank funding is excluded in all years; (2) defense funding assumes no real growth. Under the CBO baseline, the Fiscal Year 1986 outlays would be $281.9 billion for defense and $17.7 billion for international affairs.

(Prepared by the Budget Priorities Staff of the House Budget Committee.)

TABLE 2

FUNDING FOR THE NON-ELDERLY POOR
(Outlays in Billions of Dollars)

	FY 1980	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986
	Actual	Actual	Actual	Actual	Actual	Current Policy	President's Budget*
ENTITLEMENTS							
Medicaid (60%)	8.40	9.55	9.90	10.85	11.40	13.55	14.80
Food Stamps (91%)	8.30	10.25	10.00	11.50	11.40	11.40	11.55
AFDC	7.30	7.75	7.55	7.85	8.35	8.60	8.20
Foster Care/Adoption Asst.	0.25	0.35	0.30	0.40	0.50	0.50	0.55
Social Services	2.70	2.65	2.55	2.50	2.80	2.85	2.70
Child Nutrition	4.20	3.45	3.00	3.30	3.55	4.70	4.10
SUBTOTAL	31.15	34.00	33.30	36.40	38.00	41.60	41.90
DISCRETIONARY PROGRAMS							
Legal Services	0.30	0.30	0.25	0.25	0.25	0.30	0.05
Low-Income Energy Asst.	1.60	1.80	1.70	2.00	2.05	2.10	2.10
WIC/CSFP	0.70	0.95	0.95	2.25	2.40	1.50	1.50
Maternal Child Health Care	0.45	0.45	0.35	0.50	0.40	0.25	0.50
Community Health Centers	0.30	0.30	0.30	0.35	0.35	0.35	0.35
Indian Health Services	0.55	0.60	0.60	0.65	0.70	0.85	0.75
Migrant Health Services	0.05	0.05	0.05	0.05	0.05	0.40	0.50
Housing Assistance**	5.60	5.80	5.95	7.80	8.80	11.55	11.80
SUBTOTAL	9.55	10.25	10.15	13.85	15.00	17.30	17.55
TOTAL	40.70	44.25	43.45	50.25	53.00	58.90	59.45

* For the FY 1986 President's budget, the entitlement programs are estimates required under current law. Estimates do not include CBO reestimates.

** Funding for Housing Assistance assumes compliance with appropriations action in Fiscal Year 1985 to require tax-exempt financing of public housing bonds.

(Prepared by the Budget Priorities Staff of the House Budget Committee.)

TABLE 3

FUNDING FOR THE ELDERLY AND DISABLED
(Outlays in Billions of Dollars)

	FY 1980	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986
	Actual	Actual	Actual	Actual	Actual	Current Policy	President's Budget
370 Elderly and Handicapped Housing	0.75	0.80	0.75	0.80	0.65	0.60	*
500 Older Americans	0.70	0.90	0.90	0.90	1.00	1.00	1.10
550 Medicaid (40%)	5.60	6.35	6.60	7.20	7.60	9.05	9.50
570 Social Security and Medicare	152.15	178.75	202.55	223.30	235.75	254.55	269.40
600 Railroad Retirement, Black Lung	6.60	5.45	5.55	5.60	5.45	5.90	5.55
Civil Service Retirement, Military Retirement	26.35	31.30	34.35	36.50	38.05	38.85	41.25
Food Stamps (9%)	0.80	1.00	1.00	1.15	1.10	1.15	1.15
Supplemental Security Income	6.40	6.45	6.85	7.90	7.65	9.65	9.90
700 Veterans Benefits, Hospital and Medical Care	6.00	6.95	7.50	8.25	8.85	8.65	9.05
Compensation and Pensions	11.70	12.90	13.70	14.25	14.40	14.80	15.15
TOTAL	217.05	250.85	279.75	305.85	320.50	344.20	362.05

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* Less than $25 million. For 1986, the President's budget request for Elderly and Handicapped Housing was $20 million, and the proposed reduction in the Older American Act and Food Stamps was $12 million and $14 million, respectively.

(Prepared by the Budget Priorities Staff of the House Budget Committee.)

CAPITAL FORMATION

For the last four years, the Federal Government has made major efforts to stimulate capital formation, realizing that competitiveness is linked to capital formation. With Japan growing more formidable by the day and new industrial countries emerging in South America and Asia, American industry will stay competitive only by adopting the most advanced technology and efficient production processes. High levels of investment will be required.

Capital formation is a highly complex business decision which is dependent on a wide range of variables. Many of these variables are and should be beyond the control of government in a market-driven economy like ours. There are some ways, however, in which the Government can provide a climate for strong investment—by maintaining strong overall economic growth, by keeping interest rates moderate, and by minimizing the tax burden on savings and profits. In these areas, the Government should not create disincentives to capital formation or divert the flow of capital from its most productive uses.

A variety of measures has been adopted in recent years, and others have been proposed, which are aimed at increasing our national willingness to save and invest. These have most frequently taken the form of tax preferences—the investment tax credit, the Accelerated Cost Recovery System (ACRS), the capital gains exclusion, and Individual Retirement Accounts (IRA's), to name the most important provisions, along with a number of specialized tax preferences designed to channel capital into particular industries or uses. According to CBO, accelerated depreciation and the investment tax credit alone will cost the Treasury almost $200 billion in lost revenues between FY 1985 and FY 1990. The cost of all tax preferences for capital formation is even higher.

Because of these tax changes, the effective tax rate varies from one industry to the next. There is little or no tax paid by some profitable industries and high taxes paid in others. Moreover, investments are being made for tax purposes rather than truly productive purposes. Tax-favored investments are occurring that may well be of lower productive importance than other areas of capital need less favored under the Tax Code. This wastes some capital and reduces productive capacity.

There is some dispute over whether tax incentives have raised the overall level of saving and investment. The record level of gross capital formation in 1984 is cited as proof that the saving and investment incentives enacted in 1981 have had a powerful effect on the overall level of investment and should be retained. Others point out that much of this new investment is financed by a record inflow of capital from abroad and that the personal savings rate in the United States is still only about 6 percent—well below levels reached in the past. Furthermore, much recent investment has been in short-lived assets, with the result that real net investment in manufacturing, for example, is lower now than it was before enactment of the new incentives.

The importance of capital formation to competitiveness suggests that we will continue to need tax incentives to stimulate saving and investment. The important question now is not whether we should retain incentives for capital formation, but how to make those incentives more rational with fewer resulting distortions among industries and kinds of capital.

Capital formation alone, however, cannot create economic growth. It must be coupled with good management and with government policies that ensure a sound infrastructure, the development of human capital, and a positive environment for economic growth.

ELEMENTARY AND SECONDARY EDUCATION

America's system of elementary and secondary education is one of the Nation's principal economic assets. We rely upon the school system to provide young people basic skills in reading, writing, and mathematics, and to prepare them to obtain more advanced technical and professional skills beyond high school. Over 39 million young people are served by more than 15,700 public school districts at a cost of $127 billion in 1984. More than four million young people attend private schools with annual budgets of $15 billion. Public education remains primarily a State and local responsibility, but the Federal Government has a compelling interest in the quality of our public school system. The future of our international competitiveness and economic prosperity depend heavily on an effective school system.

To a remarkable degree, the Nation's schools have succeeded in carrying out their difficult tasks. Over the last generation, access to a better secondary education has been expanded to many minority groups and to the economically disadvantaged. Low-income youth are more likely to drop out of school, but a far larger portion of America's youth receives a full 12 years of schooling now than did so in the not so distant past. However, these significant gains have not been accompanied by sufficient efforts to preserve and strengthen the quality of education, especially at the high school level.

Concern over the adequacy of the public school system—particularly at the high school level—has been echoed in more than a dozen reports from across political and ideological spectrums. The signs of mediocrity noted by these studies included declines in students performance on test scores, ineffective school curricula, declining teacher quality, and shortages of teachers in critical subject areas.

Perhaps nothing so captured the attention of policymakers and the public as the gradual but continued decline in the achievement and aptitude test scores of the Nation's high school students. Until scores began to rise in 1982, verbal scores on the Scholastic Aptitude Test (SAT) had declined 50 points, and math scores had declined more than 30 points over the last two decades. The number of high achievers has declined both as a percentage of the total number of test takers and in actual number. Consistent declines also have been recorded in tests on particular subject areas such as physics and English. Colleges and universities have reported substantial increases in the need for remedial reading, writing, and mathematics instruction for freshmen.

If the college-bound high school population is not performing as well as it has in the past, the same could be said of those engaged in general education. Various reports on the quality of the high school diploma have noted that many young people are being graduated without basic functional literacy. The high school curriculum has become too diffuse, filled with too many "courses" in driver's education and other nonacademic electives, and not enough courses in English, math, the sciences, and foreign languages. Too much of the school day is being spent on idle and unfocused activities which provide little motivation for student learning and little incentive for marginal students to remain in school until graduation.

All of the major studies of the public schools also have raised serious concerns about the quality of classroom instruction. Not only are many of those now entering teaching mediocre academic achievers, but many of the most able teachers are very likely to leave teaching within their first five years. A significant portion of all new teachers in the last few years has been found in the bottom quarter of their college graduating class. SAT scores for high school seniors planning to enter education have been significantly below the national average scores for all high school students. The teaching profession is attracting fewer talented individuals to the classroom.

The shortage of qualified teachers is particularly acute in the fields of science and mathematics. The National Science Board concludes that this shortage—estimated to be more than 25 percent nationwide and growing—means that the United States is "failing to provide its own children with the intellectual tools needed for the 21st century." Qualified science teachers are being wooed away from the classroom by private firms willing to pay more than double their teaching salaries.

In the 1983-1984 school year, the beginning teacher's salary nationwide was $14,500, lower than the entering salary for virtually any professional group in the United States. The average national salary was $22,000 in 1984. Although low in comparison to many other professions, the shortage of qualified teachers may not be caused by entry salaries. It is more likely that the most qualified veteran teachers consider leaving in mid-career because they top out of the salary scale. After 15 years, most teachers reach their optimal earning power and have no opportunity for salary growth other than across-the-board or cost-of-living increases. Thus, for individuals seeking a career with the possibility of lifelong advancement, elementary and secondary teaching will not be economically attractive.

Before any of the various commissions on education excellence issued their reports, many States and local school districts had already initiated efforts to upgrade the standard of American education. Their efforts, along with the recommendations of the education reports, have spawned a major reform movement in the public schools. According to the Education Commission of the States, by mid-1984 ". . . more than 250 state task forces have sprung up to study every aspect of education and to recommend changes."

Reforms at the State and local level, most of which predated the national commission reports on educational quality, have touched on every aspect of the school experience. Among the major actions already taken: increases in high school graduation requirements (41 States); new or revised student evaluation and testing requirements (37 States); State-supported academic enrichment programs (34 States); increases in teacher preparation and certification standards (35 States); efforts to address teacher shortages (26 States); and increased instructional time (20 States).

Despite the rising concern for quality education in schools, overall spending on education has increased only modestly in real terms. Per pupil expenditures increased in real dollars less than $200 from 1980 to 1984. Even with the nominal increase, teacher salaries declined in real dollars by 6 percent from 1973–1974 to 1983–1984. However, the trend may be changing. Teacher salaries in 1983–1984 showed a nominal increase of 6.2 percent over 1982–1983.

Federal spending on education also has declined 26 percent in real terms since FY 1980. Thus far, State governments have made the most substantial contribution to increased education spending, passing substantial revenue increases in several States.

The education system in the United States is facing at least two challenges. First, the labor needs of the last part of this century will demand that students achieve a higher intellectual skill level than has the majority of students in the past. Second, the increase in school achievement must come from an overall student group that is poorer and, increasingly, comes from families where both parents work. It must come from students whose parental involvement in school is minimal either from the lack of time or fear of the system, and whose membership includes an increasing proportion of minorities and children from depressed rural and urban areas.

While the primary responsibility for the governance and financing of the Nation's public school system should remain at the State and local level, the Federal Government should play an active role to ensure that the quality of schooling meets the Nation's needs for an educated citizenry.

The Federal Government has successfully promoted other educational objectives in the past. The time has come to place a greater Federal emphasis on the quality of the elementary and secondary educational experience that will complement State and local efforts to raise standards and aid educators in making their efforts more productive.

UNSKILLED YOUTH

For whatever reason, our schools as they are now structured do not reach a significant portion of the population. Job prospects for young people who do not complete high school are poor and getting worse. The school dropout problem was singled out as an area of special concern by the President's Commission on Industrial Competitiveness:

> Clearly the competitiveness of U.S. industry is threatened when many of its young workers lack the basic skills to be productive employees.

The problem of high school dropouts requires a two-layered approach. One is to improve the capacity of schools to retain and train these young people and the other is to develop programs for those who are out of school. Progress has been made in developing programs that offer high probabilities of success.

The Headstart program, which began in 1965, provides preschool education to disadvantaged children. Studies of the program indicate that two years of program enrollment, prior to beginning the first grade, will reduce the probability of a child leaving high school by 32 percent. Headstart participation also increases adult earning power and reduces the likelihood that these individuals will be incarcerated or become welfare recipients. Overall, the program returns three and one-half times its cost in benefits to society. Currently, only 13 percent of the people eligible for Headstart are served by the program. The Administration has proposed cutting the program in real dollars under the 1986 budget by more than $40 million.

For students who have already dropped out of school, the Job Corps has become a cost-effective means of providing job skills. Systematic studies have demonstrated that Job Corps graduates have a significantly higher probability of obtaining a high school degree, finding a job, and working for a higher wage than those young people who do not participate in the program. According to these studies, the Treasury receives $1.45 in additional taxes paid and reduced welfare costs for each dollar invested in the Job Corps. Presently, the 40,000 young people served annually by the Corps reaches less than 1 percent of the eligible population. Despite a record of proven results, the Administration has requested the termination of the Job Corps in this year's budget.

At the present time, the Nation's principal program for dealing with the long-term structurally unemployed is the Job Training Partnership Act (JTPA). This program, which replaced the Comprehensive Employment and Training Act in 1982, is designed to provide training and job search assistance to low-income and long-term unemployed people. At its present level of funding, however, JTPA resources can serve no more than 4 percent of the eligible population. Reliable evidence on the effectiveness of the program is not yet available. Moreover, anecdotal evidence on program performance is mixed. As a result, a large portion of the chronically unemployed is not effectively served with programs that promise increased job skills and an improved chance for stable employment.

HIGHER EDUCATION

A strong public and private system of higher learning in the United States has produced one of the world's most highly credentialed populations, and a steady supply of talented individuals whose work contributes to economic prosperity and growth. While our investment in higher education has paid important dividends, some serious concerns have been raised about the quality of the higher education learning experience and the mismatch between the specializations of people graduating from higher educational institutions and the demands of our society. These concerns have emerged at a time when we are beginning to realize that higher education must play a central role in promoting economic competitiveness.

American higher education is a major industry. Over one-half of all high school graduates enroll in a college or university. And approximately half of them graduate with bachelor degrees. No other nation, except Japan, comes close to this rate. Total enrollment in the 3,280 institutions of higher learning stood at 12.4 million in 1983, with 78 percent of all students in public-sector schools. Nationwide, more than $90 billion was spent on higher education, with the Federal Government contributing 11.9 percent of the costs, primarily through grants and loans to students. During the last decade, overall enrollment increased by about 35 percent, but the enrollment of women rose by 61 percent, and minority participation jumped by 85 percent. Although enrollment in post-secondary institutions has leveled off in recent years, it continues to rise for women and minority groups.

Just as the Nation's elementary and secondary schools have been criticized in recent years, institutions of higher education have been criticized for graduating people who do not have a mastery of basic language and mathematics skills. Blue ribbon commissions appointed by the U.S. Department of Education and other private groups have worried aloud about the decline in the quality of higher education. Whether justified or not, these criticisms have contributed to substantial curricular change.

Colleges of all types are giving greater emphasis to the competencies and skills learned by students. A recent survey conducted by the American Council on Education found that close to half of all colleges and universities are reviewing admissions requirements with an eye toward upgrading them if possible. The Committee views that as a good development. Four in ten institutions have instituted college-wide writing requirements and most have established cooperative programs with business and industry to help ensure that graduates meet the expectations of employers. Nevertheless, only a few institutions require a comprehensive examination in a student's major. And equipment for teaching and research is declining in quality. Substantial capital investments may be required in the sciences and in computers if American institutions of higher education are to maintain their preeminence.

At the graduate and professional levels, there are serious shortages in such specialized fields as math, computer sciences, and engineering, while there are substantial excesses in such fields as law and business. In 1983, for example, U.S. law schools graduated nearly 42,000 lawyers, yet only 78 percent of them obtained full-time positions in the practice of law within a year of graduation, and nearly 10 percent were unemployed—a rate that was both higher than the national average for the working-age population and nearly three times the unemployment rate of college graduates.

In contrast, U.S. engineering schools produced only 60,000 of the 100,000 engineers demanded by business and industry in 1983, according to the Business-Higher Education Forum—a group of corporate leaders and university presidents.

With half the population of the United States, Japan produced 73,000 engineering graduates in the same year. The American Electronics Association estimates that, between 1983 and 1987, U.S. higher education institutions will graduate only half of the 200,000 electrical engineers and computer scientists demanded by business and industry. The vacancy rate for faculty in engineering schools is over 10 percent and nearly 25 percent in such fields as electronics and computers. To help meet the shortage, large numbers of foreign nationals have been recruited to U.S. graduate schools. Over half of all the Ph.D.'s in engineering granted in the United States last year went to foreign nationals.

A major objective of colleges, States, and the Federal Government has been to increase educational opportunity by reducing financial barriers to college attendance for students. There are shortcomings in the way access to higher education is financed. Young people from low-income families may receive significant Federal grants, but these are generally still insufficient to allow the many highly gifted students to attend a number of the Nation's private institutions for which they are academically clearly eligible. In contrast, young people from wealthy families can afford to attend any school to which they gain admission. Currently, the Administration has recommended changes in higher education financing at the Federal level that would squeeze out many students who come from low-income and middle-income families. Methods of financing higher education need to be examined and strategies devised that reduce the disparities between student need and the aid actually available under the program. This is not just a matter of equity. It is a matter of economic self-interest. To keep our competitive edge in the world, we need to marshal the best minds in America to attack the toughest problems in America. It is in America's interest to assure that entry into first-rate institutions of higher education is based not upon how many dollars parents have in their pockets, but on how much talent students have in their heads and how much determination they have in their hearts.

The Federal Government also must become more concerned about the quality of educational curriculum and the supply of educated people in fields that are growing rapidly in the economy. As Robert Swanson, President of Genentech, recently warned, the U.S. advantage in many industries:

> * * * is threatened, not by the failures in American inventiveness, but by potential shortages in manpower. Scientifically and technically trained men and women are a critical resource for keeping U.S. industries at the forefront of technical progress. In this area, we are clearly falling behind.

RETRAINING AND UPGRADING THE WORK FORCE

The U.S. educational and training system is based fundamentally on the premise that people are educated in the early years for lifelong productivity in the labor market. After one obtains basic literacy, life-coping skills, and values from the educational system, job-specific skills that may be required will be effectively supplied by private-sector firms.

Due to rapid changes in the nature of work—especially the introduction of new technologies—and aggressive international economic competition, traditional assumptions about learning no longer make sense. It now seems very likely that a large percentage of the currently employed population will require additional education and training in order to meet the changing demands of their jobs and occupations. The primary responsibility for the provision of job-specific skills and for upgrading the skills of the existing work force is properly lodged with private firms and with individuals. At the same time, a role exists in the public sector. We cannot risk creating a permanent class of unemployables because of our failure to address groups whose needs are not handled either by existing public programs or by the private sector.

In the years ahead, educational institutions and private firms are going to have to play a larger role in retraining and upgrading workers so that the Nation can compete internationally and in order to pave the way for changes in the nature of the U.S. economy that contribute to overall economic growth.

Evidence of the profound restructuring of the Nation's economy and its impact on workers and skill requirements is abundant. For example, the Bureau of National Affairs estimated that, in 1982 alone, 215,000 workers lost their jobs due to plant closings. CBO estimates that further automation in the automotive industry will eliminate 200,000 jobs in the next decade. A study of the metalworking industry concluded that most of its semiskilled and unskilled jobs could be replaced readily by robots. Most analysts agree that job displacement has thus far been minimal due to the slow pace with which U.S. industries have incorporated new advanced automation processes. But, as these new technologies are more widely applied, the loss of jobs will increase, particularly in certain industries and regions of the country.

Federal policymakers, labor unions, and management should not attempt to retard the process of change. They should help develop strategies that fully utilize the existing work force, either by retraining people for jobs in their own firms or preparing them to occupy new, growing occupational fields. Dr. Lewis Branscomb, Chief Scientist of IBM, has observed:

> Upgrading the skill of the people is an essential element in the introduction of more productive technologies. In my company, which has a full employment policy, investment in human resources was accomplished through retraining factory workers without discarding workers with obsolete skills through layoffs and dumping the problem exclusively on the educational community.

Some private employers have responded to the need for worker retraining and continuing education. The American Society for Training and Development estimates that private firms spend between $30 and $40 billion annually on formal training. Such large private firms as AT&T, Motorola, IBM, Texas Instruments, Citibank, and Sears have made major commitments to train and upgrade the skills of their employees. Their goals are similar—increased productivity, improved product or service quality, and the maintenance of a stable, motivated work force. IBM, for example, reports that it spends approximately $1,000 per employee per year on training and education. Motorola plans to allocate roughly 3 percent of its entire payroll budget to employee training programs. Human resource management has become an important component of overall strategic planning for these firms. Leading business schools have begun to offer courses in human resource management and to promote the value of worker training and retraining programs.

Despite these positive examples, major segments of industry are lagging behind. This is especially true for many small- and medium-sized firms with little in the way of extra resources to allocate for training and for older manufacturing firms where management may not grasp the importance of human capital development to the overall health of the firm.

Federal Government efforts to address the retraining and upgrading needs of society have been limited. Federal programs aimed at the adult work force are intended to help workers with the problems of temporary unemployment. The only program intended to retrain workers—Title III of the Job Training Partnership Act—serves less than 50,000 workers annually and is targeted for sharp cutbacks by the Administration.

If the problems of worker training and upgrading are not fully faced, the Nation's ability to compete internationally will be damaged along with the potential for long-term balanced economic growth. The Federal Government should examine ways to revise its tax policies in order to encourage the effective use of employees in private firms and to enhance worker retraining and job security. Federal programs that help displaced workers find new jobs and develop new skills should be strengthened and expanded. Federal and State efforts aimed at promoting the continuing education of the adult work force should be enlarged and tied more closely with those industry-based efforts that are already underway.

INFRASTRUCTURE

To enhance America's competitive edge in the world economy, the United States cannot ignore needed investment in infrastructure. The ability to move people, goods, and information quickly and to provide an adequate supply of clean water and waste disposal is essential for future economic growth and productivity.

By any measure, the level of investment in infrastructure is declining and, not surprisingly, bridges, roads, and water systems are wearing out. They are neither being rehabilitated nor replaced fast enough to meet the demands placed upon them. In some areas of the country, growth could be constrained in the future because infrastructure cannot support expansion.

Between 1971 and 1981, spending by all levels of government on highways, bridges, mass transit, water, and sewer systems—the core infrastructure systems which keep the economy moving—fell from 1.5 percent of GNP to 0.78 percent. Measured in 1972 dollars, total investment in all public works fell from $30 billion in 1965 to $25 billion in 1984, a 17 percent decline. On a per capita basis, public works investment in constant dollars dropped from $236 per person in 1965 to $142 in 1984, a 40 percent decline.

Although most of the decline in public works spending has come from the State share of the total, which fell from 70 percent in 1959 to 52 percent in 1983, the effects of the disinvestment are unmistakable and will be felt by the national economy, with costs measured in lost growth and productivity.

The Transportation Systems Center of the U.S. Department of Transportation reports that, if the Nation's roads continue their present pace of decline, by 1995, deteriorated roads will cause an absolute reduction in the annual outputs of industries as diverse as pharmaceuticals, agriculture, and tourism. Econometric studies prepared by the Transportation Systems Center indicate that, if deterioration of the Nation's highways continues, the annual costs to the economy in 1995 will include the following:

- 3.2 percent loss of GNP.
- 8 percent increase in the CPI.
- 5.9 percent decline in disposable income.
- 2.2 percent decline in employment.
- 2.7 percent decline in labor productivity in manufacturing.
- 3.6 percent productivity decline in nonmanufacturing activities.

In 1982, the Joint Economic Committee commissioned an advisory panel under the direction of its former Chairman, Henry Reuss, to study the condition of infrastructure and to make recommendations on how to finance its repair and construction. The study was based on local surveys of the infrastructure needs in 23 States. Its conclusions, which were extrapolated for the Nation as a whole, represent the best available data.

The advisory panel discovered a severe problem. Its analysis of the Nation's infrastructure needs, released last year in a study entitled "Hard Choices: A Report on the Increasing Gap Between America's Infrastructure Needs and Our Ability To Pay for Them," found that, though the country's regions have differing requirements for investment, all have widespread needs. While the Northeast and Midwest encounter growing deterioration of facilities built decades ago, the South and the West cannot keep up with new demands for expansion.

The advisory panel estimated that, to meet tomorrow's demands, the United States must increase planned spending by $450 billion through the year 2000. It estimated that, to finance repair and reconstruction of highways and bridges, $720 billion will be needed through the end of the century. Of that, only $455 billion will be available under existing programs, leaving a shortfall of $265 billion. For water supply and distribution, the spending gap is $41 billion; for wastewater collection and treatment, $49 billion; and for mass transit, $88 billion.

The advisory panel found that, while the financial requirements are large, they are also manageable. Although the $450 billion needed for infrastructure spending in the next decade and a half is a large sum, it is within the Nation's means. Federal infrastructure outlays have kept pace with inflation, but lag behind the increases in the cost of construction. In light of Federal deficits, the major share of the burden for increased infrastructure investment should rest with States and localities.

RESEARCH AND DEVELOPMENT

According to Dr. Lewis Branscomb, IBM's Chief Scientist:

> A key element in the Federal R&D strategy certainly must be a long-range commitment to the excellence of our scientific base. [It] is precisely the major asset we have had. Research is the fountain from which all the rest of our technological leadership flows. It would be the sheerest folly to allow that capability to deteriorate.

Research and development is a major tool of economic growth. Historically, countries with higher growth rates in R&D expenditures have experienced stronger productivity gains and higher GNP growth. Investments in R&D have led to new products and services, created higher employment, raised our standard of living, and enhanced the quality of life in the United States.

Private and public R&D expenditures in the United States—around $100 billion in 1984—are substantially greater than in other industrialized nations. More than half of all R&D funding is supplied by the Federal Government. In the realm of basic research, Federal spending accounted for two-thirds of the $8 billion spent in 1984. These public investments have been made largely because the risks of basic research are too high to attract private investment and because promoting a few critical areas of scientific research is clearly in the national interest.

The U.S. commitment to basic and applied scientific research has brought many benefits to the citizens of this country and the world:

- The preeminence of American agriculture is due, to a significant degree, to government-financed research and dissemination of information that began over 100 years ago. Advances in the manufacture of chemical fertilizers and in the production of high-yield seeds and healthier livestock have made American agriculture a world leader in productivity growth.
- Substantial Federal investments in health research and the biological sciences helped create the growing field of biotechnology. According to the National Science Foundation, by the end of the century, the biotechnology industry could be generating more than $40 billion in sales. This implies the creation of one million jobs. New scientific breakthroughs in this field have already led to significant improvements in the production and processing of foods.
- Government investments in the aviation industry, made as early as the 1940's, helped create an industry that remains a leader in the world marketplace. More recently, since the 1960's, government-sponsored research in the aerospace industry has led to numerous products and productivity improvements. For example, the need for lightweight and reliable circuitry helped foster the development of microchips which spurred the microcomputer industry.
- Government spending for basic and applied energy research reflects our desire to reduce dependence on foreign oil. Research into renewable energy resources, solar energy, and

other alternative sources promise substantial payoffs in the coming decade.

Despite the many benefits R&D spending has brought this Nation, we cannot afford to be complacent in the face of rising international competition. Testifying before the House Budget Committee, Wolfgang Demisch, then of Morgan-Stanley, observed:

> The Congress's role and the Government's role is to put up the research money * * * for the long-run investments which the individual private company can't afford to invest in. This is where additional effort is badly needed because at this point we are living off our seed corn.

There is nothing that guarantees our dominance in R&D and technological innovation. We must carefully assess our current strategies. While Japan and many Western European countries have invested heavily in the application of manufacturing technologies in such industries as automobiles, aircraft, and agricultural machinery, U.S. investment in such processes has been low. Government R&D spending in the United States has not been focused on projects with significant commercial payoffs. While the Governments of France and West Germany spend 10 to 15 percent of their R&D monies on industrial development, the United States spends less than 1 percent on these activities. There is growing evidence that the United States is falling behind in the commercial application of scientific discoveries and technological innovations.

We must think more strategically about how we invest the R&D dollar and we must renew our commitment to maintaining a competitive advantage in research and development.

Chapter III. WORKING TOGETHER FOR GROWTH AND EQUITY

Americans will always place a high value on individual initiative and self-reliance. Those qualities are part of the Nation's identity. They also are characteristics that can be assets in building a more efficient and productive economic system. They foster a capacity for innovation, perseverance, and hard work that should prove to be of immense value in the difficult years ahead.

But self-reliance and the preeminent role the individual plays in society should not prevent Americans from doing a far better job of working together. For the past two decades, internal disputes have dominated American economic and political life, often without recognizing that all Americans share many common concerns and problems.

Probably no other factor threatens the Nation's capacity for economic growth more than the inability to cooperate and work toward common goals.

Significant changes in tax laws, defense strategy, and domestic policy often are adopted on the basis of a series of temporary, narrow 51 percent majorities rather than on the basis of a broader consensus. That means that, as political control shifts back and forth on various issues between narrow-based majorities, public policy continually shifts as well.

The failure to arrive at broad-based agreements makes the Nation weaker. Whether corporate initiatives are being implemented or government policy being carried out, public divisiveness and the refusal of one segment or another of the population to cooperate means quick, decisive, and effective action is nearly impossible. So-called solutions created under those circumstances cost more, take longer, and quite often do not even work well.

One major conflict plaguing the capacity to work with one another is the ongoing disagreement between those focused on economic growth and those focused on economic equity.

The main problem we face is that our politics have been artificially divided into a sterile "chicken and egg" argument about what must come first—growth or equity; prosperity or social justice. Traditionally, Americans almost compulsively cluster around two supposedly separate sets of values and cultures.

The first set of values clusters around government, with its emphasis on problem solving—developing public policies to promote the common good and addressing social concerns of equity. The second clusters around the business world—the realm of economics, productivity, efficiency, growth, and the bottom line.

Our concerns about social justice are too often restricted to the first world; our concerns about prosperity, too often to the second. Liberals traditionally lay claim to the first set of values; conservatives to the second.

Within these neat categories, the business world supposedly produces, the government world supposedly distributes, and they are constantly and naturally at odds.

Those attitudes and artificial divisions are not real and they need to change. America should transcend the peculiar distinction traditionally drawn between civic culture and our business culture. Americans should not be forced to choose between civic values and business values. Liberals must pay more attention to business values and conservatives must pay greater attention to civic values. The argument between those two cultures is intellectually interesting but economically debilitating and is of little value in building America's future.

America must quit splitting hairs on means and focus on goals. The main task of political economy is to foster policies that will help establish conditions necessary to achieve long-term sustained economic growth. Without new growth, there is no new wealth to share.

The first order of business is to establish components of a strategy that will provide that growth. But that is not enough in and of itself because the highest purpose of economic growth is not simply growth for growth's sake, but rather growth to facilitate personal human growth.

In a democracy, prosperity that is not shared is prosperity soon disdained. History shows that a broad range of people must find a common interest in the Nation's economic policy if there is to be public acceptance of that policy.

Equity is the glue that holds a democratic society together. There must be widespread agreement that the benefits, opportunities, and responsibilities are distributed fairly and within certain norms of common decency. Otherwise, society's basic fabric will shred.

Nowhere is it more crucial to achieve that equity than in the tax system which enables the country to pay its bills. It is readily apparent that today's Tax Code is found wanting on the basis of equity.

On the business side, the tax burden falls unevenly industry by industry. Even within the same industry, different firms may face widely different tax burdens. Between 1981 and 1983, according to one recent study, more than half the country's 250 largest firms—including some that made billions of dollars of profit—paid no Federal tax in at least one of those years. Other firms paid 40 percent or more of their profits in taxes. That disparity may be acceptable to a convention of tax accountants, but it is not acceptable in a democratic society that requries public support of its taxing system.

These inequities are caused by various uses of tax preferences, mainly the ACRS and the Investment Tax Credit, which apply differently to different industries. As a result, investment decisions often are made on the basis of tax judgments rather than business judgments. In some measure, firms prosper or die depending on how the Tax Code treats them, rather than on how they are treated in the market.

On the individual side, persons making precisely the same amount of money can, in fact, end up paying widely varying amounts of taxes, again because of the long list of special preferences in the Tax Code. Individuals with high incomes may pay less of their income in taxes than those further down the income scale. Not only is this unfair, it means that individual investment decisions often are based on what can reduce taxes, not based on what is the most productive investment. Periodically, it is necessary to examine the tax system to assess its fairness and effectiveness in achieving public policy goals.

Because of the nature of the budget system, with direct expenditures being very visible and tax expenditures virtually invisible, these inequities and inefficiencies are hidden. They do not receive the periodic scrutiny given direct expenditures, and inefficient or inequitable tax expenditures tend to be perpetuated as much as efficient and desirable tax expenditures.

There are a number of major tax reform proposals before Congress that would make a wholesale attack on the present Tax Code. Only a few years ago, these plans would not have been taken seriously except by professional tax reformers. That is not the case today.

Even the Treasury plan makes quite clear that a consensus is developing in the country that tax reform is needed and that reform ought to reduce the share of total tax burden borne by the individual income tax. Since the 1950's, the share of Federal taxes paid by corporations has fallen from 25 percent to just over 8 percent, while the share paid by individuals has increased. Part of that shift has been desirable because it reflects legitimate efforts to strengthen modernization. But part of it is not and needs to be corrected. Indefensible inequities in the corporate Tax Code should be ameliorated so that the burden falls more equitably. Any reduction in individual taxes should fall more heavily on middle bracket and lower bracket taxpayers who cannot take advantage of the myriad special provisions that let upper income taxpayers reduce their taxes. A fairer corporate Tax Code would not make business less competitive or reduce investment because, with a sensible Tax Code, business firms will try to maximize their profits at any tax level.

Congress should enact a tax reform measure that makes the distribution of the tax burden between all taxpayers more equitable than under the present Tax Code.

And there is another problem. Sooner or later, and preferably sooner, both parties need to reach agreement on the overall level of public spending. When that is done, both parties must look at interest payments and ask whether, as a society, we are going to pay our bills. The Government today is living on borrowed money that must be repaid by our children and theirs. If this generation of Americans does not face up to its responsibilities, the result will be one of the largest intergenerational transfers of resources in the history of the country. Twenty years from now, the younger generation—workers just coming into the labor force—will be paying a substantial part of their incomes into social security to support the retirement of today's middle-aged generation. In addition, they will be burdened by the taxes to pay for the fact that we were not willing to pay our bills along the way. They will be paying the interest on the debt this generation has incurred. That is not responsible and it is not equitable.

Equity is required in more than the Tax Code. There also is a good deal of frustration in the country because a wide variety of services and subsidies are unequally applied and unequally shared by Americans.

A recent study found that there currently are more than 70 Federal means-tested income transfer programs designed to help the poor. They all provide some kind of subsidy or service to alleviate problems of poverty. These programs are necessary because, without them, some people are going to fall through the cracks. But it is possible to fiercely defend social programs for the middle class and the needy without compulsively defending the status quo.

We need to reexamine the way those services are provided and how equitably they are provided.

One of the largest Federal assistance programs is for housing. Unfortunately, when all forms of Federal housing assistance are consolidated, upper income and middle income homeowners receive almost $42 billion in Federal help, compared with just over $10 billion in aid for low-income and moderate-income persons, according to a recent study by the National League of Cities.

For those at the top, the subsidy comes through the Tax Code, which allows mortgage interest and property taxes to be deducted in computing taxable income. For those well enough off to be able to afford a house, or two houses, or three houses, the Government will underwrite the costs not just against the basic tax rate, but all the way up to the top rate so that the higher the income, the bigger the tax break. For low-income or middle-income persons who do not make quite enough to afford a house, the only subsidy is an indirect one in the form of lower rents due to tax incentives for housing from the Federal Government. For the poor, there is some assistance available for those in public housing. But there is not enough public housing to meet the need and, so, many of the poor receive no aid at all.

The idea that the Government should assist people with their housing needs is right and equitable. But the way assistance is provided is not necessarily equitable and is not cost effective.

We also can improve the fairness of programs that provide food and nutrition. One program provides lunches at reduced prices to school children. Another provides assistance to poor families through food stamps. But the eligibility requirements differ. Food stamps are issued only to the poorest of the poor, with requirements so stringent that many who qualify for assistance under other poverty programs cannot qualify for food stamps. At the other end, a provision in the Tax Code permits the well-known tax deductibility for the business lunch, with the Government picking up half the tab.

On health care, for those who are elderly and under Medicare, access to medical care is basically good, especially for those having a supplemental plan. People who work for employers who are in good enough financial shape to provide medical insurance also have reasonably good access to quality medical care. But those who work for employers that do not provide insurance and those who are unemployed often have no health care program, or one that is marginal at best. For the poor with no assets, it may be possible to qualify for Medicaid. But those who have worked hard and who have accumulated some assets may not have that option. The Government subsidizes those at the top by permitting employers to deduct premiums for medical insurance and subsidizes some of those at the very bottom. But, for those in between, there is often little or no help.

Assistance to workers who suffer unemployment also is badly skewed. Our system of unemployment insurance is front loaded. It provides fairly generous assistance to workers when they first leave their jobs. But, after that initial stage, it often provides little or no help for the long-term unemployed. A person laid off for a few weeks or a matter of months who qualifies for unemployment benefits during that time period can survive without crippling effects on his standard of living. However, if the person lives in a particular region of the country, or works in an industry with long-term problems where there is little prospect of training for a new line of work, there is little longer term assistance available. That person faces bleak hopes when unemployment insurance benefits expire. The system needs to be reshaped to provide greater equity and rationality, even it it means providing somewhat less assistance at early stages of unemployment in order to provide more substantial unemployment and job-training help later on.

A similar issue arises from the present state of welfare. Although spending for the non-elderly poor amounts to only a small (6 percent) and declining portion of Federal outlays, the perception is that it is much larger. Many Americans continue to believe that the Federal deficit virtually could be eliminated if waste and fraud in welfare were eliminated.

In truth, the system is in disarray. It is an administrative nightmare requiring far more staff and overhead than any comparable system in the world. It often provides unequal benefits to families or individuals with similar or identical needs. It provides too little incentive to work and, as some conservatives have recently pointed out, the system has become worse in the 1980's rather than better. It fails entirely to reach some in desperate need and fails to provide minimal subsistence to others. It is often demeaning and mean spirited to those who must turn to it.

Another drawback of the welfare situation is that it has become a symbol of government's inability to cope and of the persistent nature of poverty in America. It further divides the country on the issues of equity and growth.

But there are strong and obvious reasons for those interested in these separate goals to work together. The first is that, without growth, it will be difficult and maybe impossible to accomplish anything close to equity. The disadvantaged are unlikely to get a bigger share of any pie that is not growing. To do so would require that they take it from those who are not disadvantaged. That might be more fair but it does not happen very often outside of Sherwood Forest.

Second, despite concern that efforts toward economic equity undermine economic growth, it is important to improve economic equity in ways that do not harm growth but rather enhance it. A society as wealthy, as talented, and as imaginative as ours should be able to devise a strategy that both promotes equity and builds a better environment for growth if we make choices on the basis of what works rather than on the basis of economic ideology. Capital investment must share the table with education, research, work, training, and vice versa. Those are the tools that enable people to cope with inevitable change and cushion the ill effects of change in ways that facilitate change rather impede it.

A recognition of common interests can lead to better solutions, better communication, and better cooperation. That can create an environment in which all citizens come to feel that they share the risks and have opportunities to participate in the rewards of America's economic future. The recent "Report of the President's Commission on Industrial Competitiveness" states:

> A skilled, motivated, and secure work force is a prerequisite to realizing the dual goals of productivity and quality so crucial to maintaining competitive advantage.

Also needed are entrepreneurs who are willing to take risks, managers who are willing to look to long-term goals, and government officials who will keep the public sector healthy, productive, and responsive.

Given our resources, these challenges can be met if we admit we have common interests and seek common, broad-based solutions.

ADDITIONAL VIEWS

ADDITIONAL VIEWS OF REPRESENTATIVE PARREN J. MITCHELL

I commend Chairman Obey, the Democratic Members, and the Committee staff for preparing the 1985 Joint Economic Committee Annual Report. This was a difficult task because of the unexpected death of our friend, colleague, and former Chairman, Congressman Gillis Long of Louisiana. The purpose of my views is to emphasize those issues that are of critical importance to me, and not to undermine consensus with respect to Democratic views.

The American economy has experienced record growth for almost a year and a half. But some of us have acquiesced to the Administration's policies and are playing their "high-risk growth game." We all know that growth cannot be sustained without some fundamental changes in fiscal policy. As suggested in the Chairman's recommendations, "the current mix of fiscal and monetary policy should be reversed." We have already begun to witness a slowdown in economic growth to a level which left the unemployment rate for March 1985 at 7.3 percent, virtually unchanged from a year ago. Most economic forecasts project that economic growth will not exceed 3.5 percent for 1985. Thus, we should not expect real improvement in unemployment.

One consequence of the high-risk growth strategy—black unemployment—is particularly irksome to me. The unemployment rate declined from the recession peak of 10.7 percent. Even though it has fluctuated slightly since September of 1984, major segments of the labor force have still not benefited. Despite improvements in general, the rate of unemployment for blacks is still more than twice the national averge—15.2 percent. Black teenage unemployment is currently 41.9 percent, almost three times the white teenage unemployment rate.

The President has acknowledged that the Federal Government must play an important role in reducing unemployment. Yet, the only measure, other than program reductions, advanced by the President is the establishment of a subminimum wage for teenagers. I opposed this policy measure when it was first proposed by the President and so did the Congress.

In addition to black unemployment, another consequence of the "high-risk growth game" is the number of discouraged workers. There were 1.3 million discouraged workers in the first quarter of this year. The number of persons in this group has not changed for more than a year. The 1.3 million discouraged workers, 8.4 million unemployed persons, and 5.4 million involuntary part-time workers represent approximately 13 percent of the work force or more than 15 million persons. I submit that the Democratic response to these persons must be unequivocal. We must develop an economic policy that recognizes that growth alone will not absorb these persons into the labor market, and only 70 percent of manufacturing jobs have been restored since the recession.

Not only must we develop policies to address unemployment, we must give serious consideration to trends and existing policies that are crucial to our long-term economic future. One such issue is the growth of credit for both households and business and their susceptibility to unexpected developments in the economy. Although this increase in indebtedness does not immediately threaten the economy, it could present problems in the future. I submit that a policy measure to correct this practice must be one of the major goals of tax reform.

The relationship of the economic performance of the United States and the world economy must also be considered within the context of any comprehensive economic policy. The stability of other industrial countries and the developing economies is important to sustained growth and employment in our country. Our role in the international economy should be explicit.

There are serious problems confronting our basic industries. The overvalued dollar is partly responsible for the short-term problems of some of our industries, particularly those which export. There are problems in industries—steel, semiconductors—which must be addressed if these industries are to compete and contribute to the growth of the economy.

Another major issue of concern to me is the role of the financial system and present business practices in the financing of industrial investment. This issue demands the cooperation of government and the banking system. Without this cooperation, we will not be able to meet our long-term investment needs. Traditional methods of financing industrial investment will simply not work in a competitive international economic system.

In general, the report discusses the threats to our long-term economic well-being. However, it is also essential that we establish goals with respect to productivity, inflation, employment, and growth, as measures of our economic well-being. In so doing, we would provide the American people with an idea of how the reversed fiscal policy mix that we advocate will benefit them.

ADDITIONAL VIEWS OF REPRESENTATIVE AUGUSTUS F. HAWKINS

Chairman Obey, the Democratic Members, and staff are to be commended for the effort involved in preparing the recommendations and accompanying views presented in this report. In addition to the positions already expressed, I would like to offer the following comments to more clearly state my individual views.

The JEC Report should respond to the Economic Report of the President.—The JEC is given the statutory authority to review and analyze the Economic Report of the President, and to also make recommendations as to the proper policies and programs which should comprise an economic agenda which will attain the goals of full employment and price stability.

In order to make some sense out of the Federal Government's economic policy decisionmaking process, we must set quantitative economic goals, and then we must talk about how we are to reach those objectives. As the copartner in economic decisionmaking, the Congress, through the JEC, has the responsibility to respond to the program set forth by the President in the Economic Report and, if we do not agree, then we should clearly and comprehensively set forth alternatives.

We should state that our economic goals are; we should detail the proper mix of fiscal, monetary, and structural policies and programs needed to achieve those goals; and finally we should use every means available to us to influence the actions of other committees of the Congress to incorporate these goals and policies as the foundation of their individual authorization, budget, and appropriations actions.

In this regard, I do not believe it is appropriate for the JEC to issue a separate Full Employment and Balanced Growth Act report as an attachment to this report. While I am encouraged to at least see a discussion of the problem of unemployment as it regards overall economic policy decisionmaking, the Act requires that such a discussion be a central factor in the JEC's Report on the Economic Report of the President. Such a discussion is a glaring omission from the body of this report.

Setting National Priorities.—I have stated before and I continue to believe that undue emphasis is being placed on the issue of deficit reduction as the primary means to achieve a so-called "growth with equity" society. Deficit reduction is the end result of pursuing policies which reduce unemployment and inflation. Cutting programs merely for the sake of deficit reduction flies against common sense and is bad economic policy.

All programs should be looked at in terms of their individual merit, and analyses should be made as to what contribution they make to the individuals who are the intended recipients as well as to the economy as a whole. Budget decisions should then be based on these more rational characteristics.

The Federal budget is not just a mass of statistics. It is the primary tool we as policymakers have to meet our national priorities. We should not be deluded into settling for a policy that is based on ideological prejudice as opposed to economic justification. The Federal Government has a proper role to play in many endeavors, and deficit-reduction fever should not be used as an excuse to lessen that appropriate Federal influence.

Depression Amidst Recovery.—While the report contains a discussion of the disparities which continue to plague certain segments of society and sectors of the economy, I would like to augment that discussion to some extent. I do not believe adequate expression is given to the pressing national priorities of expanding job opportunities for both economic as well as moral reasons.

While official unemployment rates give some indication of the misery being suffered by millions of our citizens, it does not accurately reflect the widespread nature of such suffering. The official statistics do not count the so-called discouraged workers—those who have given up looking for work—nor are those working parttime for economic reasons counted in the monthly overall rates. In the most recent month for which statistics are available, a more accurate rate of unemployment would be close to 13 million persons nationwide. Such levels are extraordinarly high by historical standards.

This involuntary unemployment represents not only human suffering and travail, but also represents a drain on the economy in the form of contributing to the budget deficit to the tune of $25 to $30 billion for every 1 percent increase in the unemployment rate. These reasons alone should move us to take steps to address this festering problem. It is wholly appropriate to support a targeted jobs program in the current economic situation.

A well-crafted program putting people to work in needed areas and providing needed services will not only serve to aid the individuals who need help during a time of personal and family crisis, but will greatly aid our efforts to bring about lower budget deficits.

REPUBLICAN VIEWS

"On the Road to Opportunity"

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Chapter I. ON THE ROAD TO OPPORTUNITY

INTRODUCTION

America today is the strongest, most productive economic power in the world. Free market capitalism is the basis of America's economy, and has demonstrated once again that it is the best means to achieve long-term growth and expanding opportunity. The Republican Members of the Joint Economic Committee note the progress in the economy the last two years. Suffice it to say that we are on the road to opportunity for all Americans.

The market economy, however, as a process of change and growth, is never in equilibrium and continuously generates new problems as well as opportunities. While the brisk economic recovery of 1983-1984 served to uncover transitional structural problems in our economy, it also served as strong evidence of the effectiveness of Reagan Administration economic policies. There is a need, however, for the Congress and the Administration to develop and implement policy actions which are especially sensitive to these transitional structural problems and thereby complement, sustain, and expand the current economic recovery.

BEYOND THE ECONOMIC RECOVERY: A GENERATION OF GROWTH

More than two years of economic growth have been achieved since the end of 1982. The short-run objective of bolstering a strong economy has been accomplished. The challenging task remains of implementing policies which will foster long-term, sustainable economic growth without inflation. A generation of real economic growth is not beyond realization.

The key to achieving a generation of growth is the implementation of Federal policies which foster the long-term competitiveness of our economic system. As a general guideline, U.S. economic competitiveness will be enhanced by Federal policies which reduce Federal spending, taxation, and regulation, and raise private-sector savings, investment, and self-reliance. This policy guideline must be coupled with a stable monetary policy which will accommodate growth. Competitiveness is a market phenomenon, and cannot be centrally planned, managed, or legislated.

Within this policy guideline for a generation of growth, several Federal policies need to be pursued during this session of Congress.

Federal Spending.—The rate of growth in Federal spending must be reduced and must become a declining share of gross national product (GNP). A $50 billion reduction package for fiscal year 1986 (including entitlements and defense) must be coupled with a long-term policy commitment that the growth rate of Federal outlays will, at least, be kept below the real growth rate of GNP. The Congress should immediately provide the President with line-item veto authority on appropriation bills.

Federal Taxation.—Federal taxation, like Federal spending, has no automatic claim on any portion of this country's gross national product. Federal taxation must become a declining share of GNP. After all, real GNP is a measure of the economy's ability to pay. To the degree that taxes are levied, it is only reasonable that our citizens be assured that the method of collection be as fair and simple as possible. Any expansion in the tax base must be accompanied by a reduction in the income tax rates, including the elimination of Federal income taxes on incomes at or below the poverty line.

According to the Congressional Budget Office, the surplus in the Social Security Trust Fund is projected to grow from $8 billion in 1985 to $54 billion in 1990. In the event of accumulation of any unreasonable and unnecessary trust fund surpluses, the Congress needs to consider a reduction of social security payroll taxes. This is especially true if cost of living adjustments of social security benefits are frozen by action of the Congress.

Savings.—Personal savings are the seed capital in new investment. Increasing saving as a percent of disposable personal income is, therefore, essential for long-term economic growth. A growth-oriented savings policy would include maintaining a low level of inflation through a responsible monetary policy and tax policies which avoid punitive treatment of returns to savings. In addition, positive incentives to promote greater saving should be passed by the Congress.

Investment.—Investment in physical and human capital is needed to expand the productivity and competitiveness of the economy. Any tax reform measures must be supportive of investment incentives.

Current investment incentives such as accelerated depreciation schedules, the incremental R&D tax credit, and the capital gains exclusion must be protected, if not extended further. Consideration should also be given to permitting individuals to establish special tax-sheltered accounts for funds being set aside for college expenses of family members. The deductibility of all savings for whatever purpose also should be considered.

Investment in human capital can also be promoted by supporting the Job Training Partnership Act of 1981; implementing a youth summer subminimum wage; pursuing the recommendations of the National Commission on Excellence in Education calling for a commitment to upgrade U.S. educational standards, particularly in math and science; and by improving U.S. Employment Services functions to facilitate labor mobility. Congressional approval of the President's urban Enterprise Zone proposal is long overdue.

Reform of the Federal Reserve.—The influence of the Federal Reserve System on some sectors of the economy is as great as that of the Congress and the Administration. Yet it lacks comparable scrutiny and accountability. Congress should encourage the Board of Governors of the Federal Reserve System to maintain a steady and predictable monetary policy. Frequent switches in monetary policy lead to increased volatility and market uncertainty and should be minimized as much as possible.

International Trade.—Whether the world is on the threshold of an era of new achievements or on a serious downward spiral into economic isolationism, depends, in large part, on how the United States approaches international trade problems. We need to vigorously pursue trade liberalization policies at home and abroad. Tendencies to protectionism, while understandable, are wrong. U.S. trade and policy officials should aggressively work, particularly through new multilateral trade negotiations, to knock down trade barriers abroad, so that trade can be on a fair and free basis. This "gloves off" approach is particularly important for the agriculture sector of our economy. Securing a fair and free international trade environment which pits U.S. farmers against their foreign competitors, one on one, will go a long way toward reviving the agricultural and rural economies.

Agriculture and Rural America.—Despite record Federal expenditures and the proven productivity of the American farmer, agriculture remains in economic recession. Federal programs have done a tremendous disservice to the agricultural community. They have crippled the most efficient producers of the world's most valuable commodities. Viewed from a global perspective, U.S. farmers should be the last to go broke.

Federal farm policy needs to effectively and responsibly address the current financial crisis in agriculture and then phase in more market-oriented farm programs as world agriculture becomes more market oriented through fewer and lower trade barriers. Also, few sectors of the economy have been more victimized by high real interest rates and the high foreign exchange value of the dollar than agriculture. Major reductions in the Federal deficit are paramount in achieving economic recovery in agriculture and in rural areas.

Privatization

Over the years, we have gradually but steadily transferred the responsibility for financing, supplying, and managing a staggering number of services from the private sector to government. Numerous case studies have documented that, where the same or similar service is being offered by both private and public entities, the private-sector alternative is most cost effective.

The Congress and the Administration should begin a concerted long-term effort to systematically transfer, from government to the private sector, services which the private sector, can provide in a more cost-effective manner.

CONCLUSION

Change is inherent in the American economy. The American market economy is designed to generate change and growth and dynamic capitalism is the source of enhanced competitiveness. Change, by definition, however, causes social as well as economic dislocations and, therefore, is frequently resisted. But these dislocations should only be transitional. The role of government in a free-market economy is not to manage change to avoid dislocations for this will only lead to stagnation and reduced competitiveness. Rather, the role of government is to facilitate and stimulate change by minimizing the social and economic trauma of dislocation. Allegiance to general policy guidelines of reduced Federal spending, taxation, and regulation, and the promotion of greater private, sector savings, investment, and self-reliance will serve us well in the future.

Chapter II. ECONOMIC REVIEW AND PROSPECTS

INTRODUCTION

For the U.S. economy, 1984 was a good year, and in some respects a great year. Real GNP rose 6.8 percent, inflation remained in the modest 4 percent range, and civilian unemployment fell from 8.0 percent in January to 7.2 percent in December.

For most major economic statistics, 1984 was a better year than the good recovery year 1983. Only in the case of imports did conditions worsen in 1984.

Table II.1 shows the annual percentage rates of change, or the status, of major economic measures during the recession year 1982 and the recovery years 1983 and 1984.

TABLE II.1.—THE U.S. ECONOMY—SELECTED ECONOMIC MEASURES

[Annual Percentage Rates of Change, Unless Otherwise Noted—1982, 1983, and 1984]

	1982	1983	1984
Real gross national product	−2.1	3.7	6.8
Consumption	1.4	4.8	5.3
Residential investment	−15.0	41.7	12.2
Business fixed investment	−4.7	2.5	19.8
Equipment	−6.8	7.3	21.5
Structures	0.2	−7.8	15.6
Exports	−7.8	−5.5	4.7
Imports	1.3	7.6	26.9
Federal Government purchases	6.1	−0.6	5.4
State and local government purchases	−0.6	0.0	2.2
Unemployment rate (civilian percentage)	9.7	9.6	7.5
Consumer prices	3.9	3.8	4.0
GNP deflator	6.0	3.8	3.8
New car sales (million units)	8.0	9.2	10.4
Housing starts (million units)	1.1	1.7	1.7

Soruces: U.S. Department of Commerce, U.S. Department of Labor, and Data Resources, Inc.

Some analysts pointed to the economic slowdown in the third quarter of 1984 and wrongly concluded "imminent recession."

That economic slowdown became a temporary lull. Prolonged economic recoveries often include a few quarters of below-trend growth. In fact, some would argue that a pause at that stage of the business cycle was actually healthy. The 10.1 percent growth in real GNP in the first quarter of 1984 followed by a strong 7.1 percent growth in the second quarter was an unsustainable pace.

The third quarter slowdown proved not to be a prelude to recession. The ingredients for recession were just not there—rising prices, rising interest rates, excessive inventory buildup, production bumping up against factory capacity, labor shortages, consumers overburdened with debt, and serious sector imbalances. A cyclical downturn typically occurs because of stresses that build during an expansion. As the economy grows, strong demand creates shortages, bidding up prices and interest rates. None of these early signs of recession are present in the economy.

The most apt characterization of the outlook for 1985 is sustainable noninflationary growth. The recent decline in interest rates will help set the stage for a resumption of good economic growth.

The current U.S. economic expansion entered its third year in November 1984. By historic business cycle standards, this takes it out of the age of youth and into middle age, and middle age brings with it a slowdown in the pace of growth.

The average age of post-World War II expansions (including the Korean and Vietnam war periods) is 45 months. If the current expansion is typical, that means it would run until about August 1986. However, it is possible that this is a better than "average" recovery and it could be sustainable for 50 months, or into early 1987.

Barring oil embargoes, overly restrictive monetary policy, or other economic calamities, the U.S. economy may be in for at least two more good years of economic growth—not aggressive growth of the 1983–1984 variety—but good solid economic growth nonetheless. With the recent economic pause behind us, GNP for the year 1985, as a whole, should rise about 4 percent.

WHERE HAVE WE BEEN?

To gain further perspective on where the U.S. economy is, it will be helpful to review some history on where it has been.

For the better part of 20 years, two serious and fundamental economic problems plagued the United States—stagflation and deteriorating productivity. Because of their economic and political importance and because of their influence on the new direction of economic policy in the 1980's, it would be well to review this era of U.S. economic history.

Stagflation—Rising Unemployment and Inflation

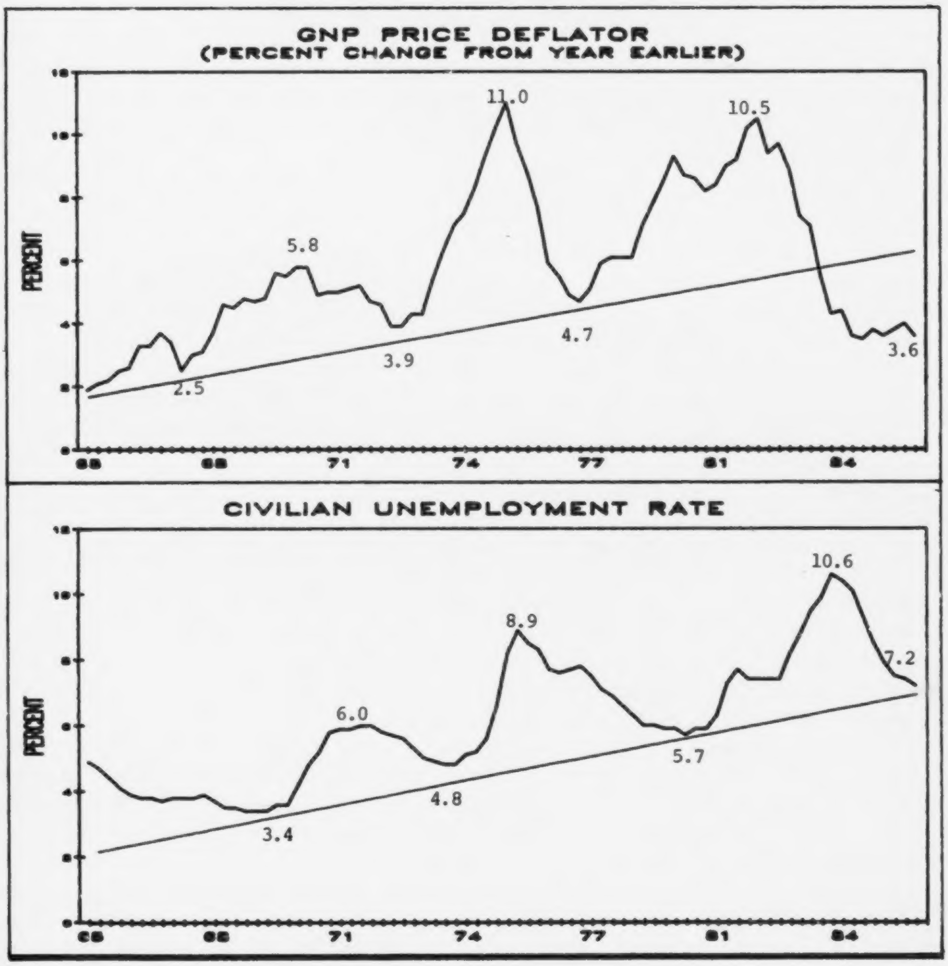
For about a decade and a half, from the mid-1960's to 1980, the U.S. economy was on a reverse roller coaster, with unemployment and inflation being propelled upward to higher and higher peaks and troughs. Over this period, unemployment and inflation often fluctuated together—not as offsets to each other as called for in Phillips Curve theory—but as unholy companions—rising to higher and higher peaks and troughs, and a new economic label became a household word: stagflation.

This unhealthy phenomenon is illustrated in Chart II.1 below:

CHART II.1

INFLATION AND UNEMPLOYMENT

QUARTERLY DATA, 1965Q1 - 1984Q4



SOURCE: U.S. TREASURY DEPARTMENT AND JOINT ECONOMIC COMMITTEE

The major good news in Chart II.1 is that the inflation uptrend line was convincingly broken in the last half of 1982, and it is anticipated that the unemployment rate uptrend line will also soon be broken.

In the fourth quarter of 1984, the GNP price deflator rose only 3.6 percent over the fourth quarter of 1983, well below the trend line and substantially below the inflation peaks of the first quarter of 1975 and the first quarter of 1981.

At 7.2 percent, the fourth quarter 1984 employment rate is nearing the trend line and should head into new low ground in 1985 and 1986, although the pace of decline may slow down from the steep drop in 1983 and 1984.

Deteriorating U.S. Productivity

For the first two decades following World War II, the United States was without serious challenge as the economic leader of the world. The United States came out of the war unscathed and, while there were three U.S. recessions in the 1950's and 1960's, the general trend was very strongly positive. It took some of our industrial competitors about two decades to recover from the devastations of World War II, but these industrial competitors are coming on strong now.

One of the best measuring rods of the general health of a nation is productivity—the output per employed person per hour worked. While the United States still leads the world in total productivity, the gap has been greatly narrowed. From the mid-1960's until 1980, something began to turn sour in the U.S. economy. Productivity, measured by the output per worker per hour in the private business sector, rose at a 2.6 percent compound annual rate in the 1950's, and 2.8 percent in the 1960's. In the 1970's, productivity growth was cut in half, growing at a meager 1.4 percent per year over the decade, and actually declined in 1979 and 1980. Along with productivity, real GNP grew by 3.3 percent per year in the 1950's, and by 3.9 percent in the 1960's, slowing to 3.1 percent in the 1970's, but was essentially flat over the period mid-1979 through 1982.

Total U.S. productivity has led the world throughout the postwar period and still leads the world. But other nations are closing the gap. Using the benchmark of 100 for the United States, the relative index of real domestic product per employed person in six industrial nations is shown in Table II.2. This is the only broad-based measure of productivity available for international comparisons.

TABLE II.2.—REAL DOMESTIC PRODUCT PER EMPLOYED PERSON—RELATIVE LEVELS: PURCHASING-POWER PARITY EXCHANGE RATES

	1950	1960	1970	1980	1983
United States	100.0	100.0	100.0	100.0	100.0
Canada	84.3	88.1	91.9	94.1	92.1
France	43.9	55.7	73.5	93.2	94.4
West Germany	39.6	60.2	75.0	92.3	93.9
Italy	27.8	39.7	59.0	69.3	66.4
Japan	17.5	26.9	52.0	70.8	73.7
United Kingdom	53.6	54.1	57.0	62.1	66.1

Source: U.S. Department of Labor, Bureau of Labor Statistics.

The United Kingdom is the only nation that is not gaining very fast on the United States in productivity, rising from an index of 53.6 in 1950 to an index of 62.1 in 1980 and 66.1 in 1983. Japan, on the other hand, while still trailing the United States by a wide margin, has had the fastest percentage rise of any nation—from an index of 17.5 in 1950 to 70.8 in 1980, and 73.7 in 1983. France, Germany, and Italy have all had rapid productivity increases in the postwar years, and Canada, France, and West Germany are now approaching the United States in total productivity per employed person. While the United States gained somewhat on Canada and Italy from 1980 to 1983, it is clear from the general picture shown in Table II.2 that, if the United States does not turn its productivity around, it will not be long before several other nations overtake us in total output per worker, as well as in rate of increase.

Poor productivity performance in the United States was at the heart of a lot of economic ills in the 1970's, both reflecting the ills and causing them. When productivity rises, or falls, so does the rate of economic growth, real wages, and the standard of living.

The long period of stagflation—rising unemployment and inflation—and the terrible productivity performance in the 1970's called for a new economic policy direction. The new policy emphasis was on productivity and economic growth. Under the leadership of Chairman Lloyd Bentsen, and Ranking Minority Member, Clarence J. Brown, the Joint Economic Committee successfully argued the case that the solution to the stagflation of the 1970's lay in policies to expand the supply side of the economy by raising the country's productive potential. This did not mean casting aside the demand side but simply recognizing that there are two blades to the economic scissors—demand and supply. In short, this theory was to produce our way out of both inflation and unemployment. Policies that produce slow or negative growth will not produce price stability, nor will they address the problems of structural unemployment.

Productivity was to be the linchpin of economic progress in the 1980's, and with rising productivity comes rising GNP and rising living standards for all Americans. The Reagan economic program addressed tax and regulatory barriers to production. It recognized the need to save more, invest more, and train more disadvantaged Americans for productive work. Specifically, the goal was to fight both inflation and unemployment at the same time with a four-plank economic package—reduced tax burdens, reduced government spending, reduced government regulation, and responsible monetary policy.

The Reagan economic package sought to persuade the independent Federal Reserve Board to follow a course of steady and moderate monetary restraint. The Administration, however, was not very successful in securing from the Federal Reserve steady monetary growth. The average posture was one of restraint, but gyrations in monetary growth were devastating to the money markets. The precipitous decline in the growth of money from the fourth quarter of 1980 through the first half of 1981 was a major contributor to the 1981-1982 recession.

THE RECESSION AND RECOVERY

The 1981–1982 recession began in July 1981 according to the National Bureau of Economic Research, the research institution that dates U.S. economic cycles. The growth and anti-recession policies of the Reagan Administration were not enacted until the late summer of 1981, and implemented incrementally over several years. Thus, the Reagan economic program was a victim of certain economic conditions—namely, recession and high interest rates—that it did not cause.

The 1981–1982 recession was severe. The civilian unemployment rate rose from 7.2 percent in July 1981 to 10.7 percent in November 1982. Industrial production fell by 12 percent over the same period. Corporate profits, before taxes, fell 23 percent and real GNP fell 3 percent from the third quarter of 1981 to the fourth quarter of 1982.

As the recession was pervasive and serious, the recovery has been extensive and impressive. From the trough of the recession—November 1982—through the end of 1984, there have been the following improvements in these significant statistics:

The civilian unemployment rate is down from 10.7 percent to 7.2 percent.

Industrial production is up 22 percent.

Corporate profits, before tax, are up 92 percent.

Real gross national product is up 12 percent.

CURRENT RECOVERY VERSUS "TYPICAL" RECOVERIES

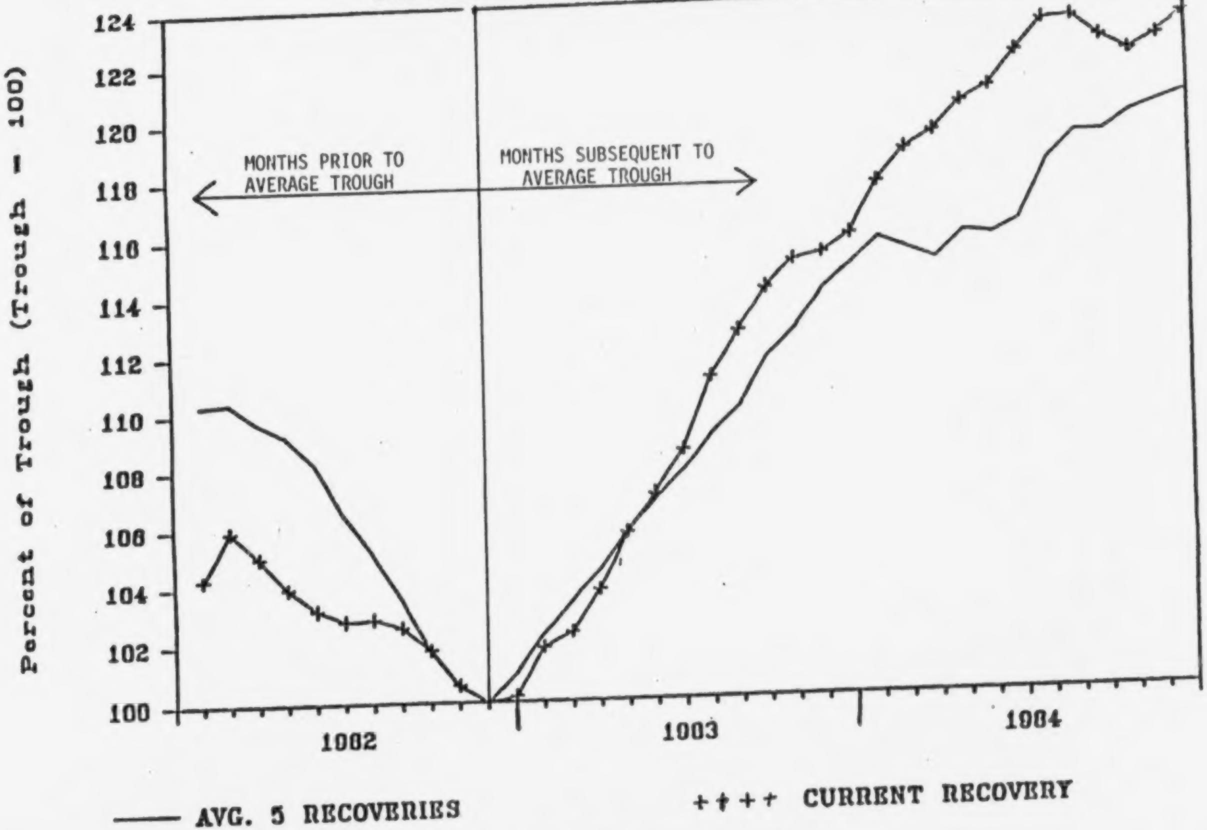
The current economic recovery compares very favorably with the five previous post-World War II recoveries. In the charts and table below, the current recovery is compared with recoveries from the 1954-II quarter, 1958-II quarter, 1961-II quarter, 1970-IV quarter, and 1975-I quarter recession troughs. The current recovery is measured from the recession trough 1982-IV quarter.

Chart II.2 shows the path of industrial production as a percent of the recession trough (trough = 100) for the current recession and the average of five previous recoveries. Clearly, the current recovery is above average.

Chart II.2

INDUSTRIAL PRODUCTION

COMPARISON WITH 5 PREVIOUS RECOVERIES



Source: Council of Economic Advisers and Joint Economic Committee

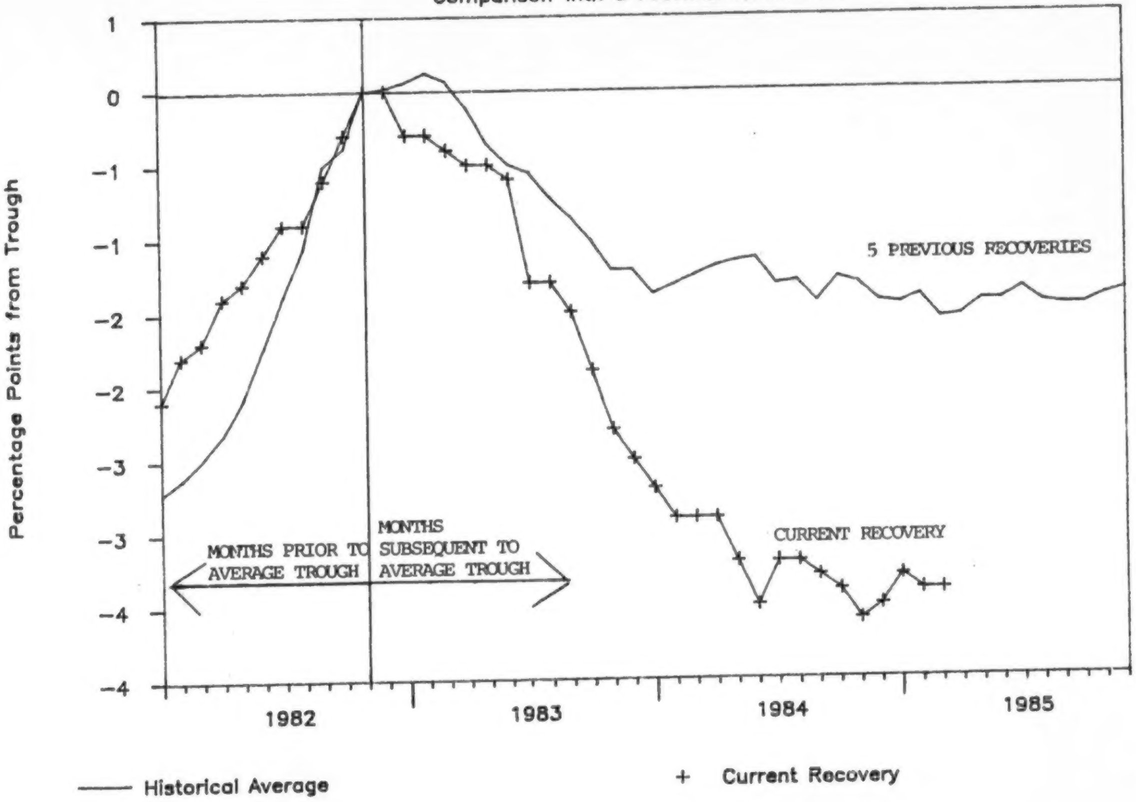
The most impressive statistics in the recovery are in the labor markets. As of December 1984, the U.S. economy had created 7.1 million civilian jobs in two years. This is the fastest two-year job growth on record and, while the pace should slow this year, there is no reason to believe that good job performance will not continue following, perhaps, a sluggish first quarter of 1985.

On the other side of the coin, the unemployment rate has dropped sharply during this recovery and far outstrips the performance of five previous recoveries. Chart II.3 shows the percentage points decline in the unemployment rate over two years from the recession troughs. The latest trough was November 1982.

CHART II.3

CIVILIAN UNEMPLOYMENT RATE

Comparison with 5 Previous Recoveries



Source: Council of Economic Advisers and Joint Economic Committee

Table II.3 shows economic growth over the first eight quarters for "typical" recoveries (average of five previous recoveries) and for the current recovery. Note, first, that real GNP has grown at a 6.0 percent annual rate in this recovery compared to 5.3 percent in five previous recoveries. In all of the most significant components of GNP—personal consumption, residential construction, inventories, and particularly in the case of business fixed investment, this recovery exceeds the "typical" recovery.

In some respects, the change in business inventories may be a mixed blessing if the buildup comes too fast, but the inventory growth, to date, appears to be at a healthy, sustainable pace. During the 1981-1982 recession, there was an enormous amount of inventory liquidation, and business is now doing some restocking, but inventory to sales ratios are still very low; there are no signs of an excessive inventory buildup.

The only negative component in Table II.3 is net exports and, more specifically, the sharp rise in imports, due to a strong U.S. economy, relative to other economies, and as a result of a strong U.S. dollar. The U.S. trade situation and the international economic situation in general are discussed in Chapter VII.

TABLE II.3.—CONTRIBUTION TO GROWTH—"TYPICAL" AND CURRENT RECOVERY

[Sector Contribution to Growth in Real GNP from the Trough Quarter, Percent Annual Rate]

	First 8 quarters	
	Typical [1]	Current [2]
Real GNP	5.3	6.0
Personal consumption:		
Expenditures	3.2	6.0
Durables	.9	1.2
Residential	.5	.6
Business fixed investment	.6	1.7
Nonresidential structures	.1	.2
Producers' durable equipment	.5	1.5
Change in business inventories	.7	1.4
Net exports	−.1	−1.2
Exports	.4	.3
Imports	.4	1.6
Government	.3	.3
Federal	−.1	.2
Federal Excl. CCC Purchases	−.1	.4
State and local	.4	.2

[1] Average of recoveries from 1954–II, 1958–II, 1961–II, 1970–IV, and 1975–I recession troughs.
[2] Calculated from 1982–IV current recession trough.

Source: Council of Economic Advisers.

There is an abundance of other good economic news that demonstrates that this economic recovery is on solid ground. In fact, except for our twin deficits—the fiscal deficit and the trade deficit—most major economic measures are healthy.

Factory Use

The sector of the economy hit hardest by the recession—factory production—is back on line. Factory use has risen from the recession low of 69 percent to 81 percent. While there has been a leveling of capacity utilization since the early summer of 1984, this is not unexpected nor unusual; further increases in 1985 and 1986 are expected, but at a more modest pace. Factories usually operate at less than 100 percent of capacity—from 1963 to 1983 the average was 82.6 percent, slightly above where factories are operating right now.

Business Fixed Investment

As shown in Table II.3, business fixed investment contributed 1.7 percentage points of real GNP growth during the current recovery, about three times the typical contribution. The strength of investment has been concentrated in durable equipment. From a decline of 4.7 percent in the recession year 1982, nonresidential fixed investment rose by 2.5 percent in 1983. Equipment investment rose by 7.3 percent, but investment in structures declined in 1983 by 7.8 percent. In 1984, however, real investment growth was at an aggressive 19.8 percent pace—21.5 percent in equipment and 15.6 percent in structures. A slower pace of about 8 to 10 percent in total business fixed investment is expected in 1985. Factors in the expected slower investment pace in 1985, compared to 1984, are: (1) reduced profits in 1985 and the need for more external financing and (2) uncertainties regarding the course of tax policy in 1985, plus some lingering effects of the "take back" of tax incentives in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Consumer Spending

Consumers helped fuel the recovery. Personal income is still rising, employment is up, confidence is high and, while there was a slowdown in the pace of retail sales from July through October 1984, they rose a healthy 10.4 percent for the year 1984 as a whole (the best performance in five years). This growth occurred across a broad range of items—both soft goods and durable goods, including automobiles. New car sales were 10.4 million in 1984—including 8 million in domestic sales. Continued pent-up consumer demand should make 1985 and 1986 good automobile years also.

Housing

The sector that set the economy on its roll early in the recovery was housing. Private housing activity had fallen to a record low in October 1981 when total new starts were only 854,000 units. After hovering around one million units or less for the next 12 recession months, total housing starts began an upturn late in 1982 that proved to be one of the strongest housing recoveries on record. This is somewhat surprising in view of interest rate levels that were substantially above the rates prevailing during past housing booms and only serves to underscore the underlying strength of the housing sector. Housing starts totaled 1.7 million in 1983 and nearly 1.75 million in 1984, with a couple of 2 million plus months early in 1984.

Although new housing starts peaked early in 1984, and dipped to an annual rate of 1.6 million per month late in the year, the carryover effects of the 1983-1984 housing boom will have strong ripple effects for many months to come. A housing start is just that—a start—and the contributions to GNP and employment carry over for several months while the home is being built, and then, later, there are important spinoffs in furniture, furnishings, appliances, and even autos.

The peaking in housing construction, early in 1984, was not unexpected and is not considered a serious problem. Construction as a whole is going through its typical cycle. Housing leads out, followed by stores and commercial construction, then comes factory construction and, finally, office buildings. This typical pattern is in full operation right now. Commercial construction has been strong, and plant construction is in its early stages of expansion. We may not see an office building expansion, however, since office space is in surplus, particularly in the southwest. But the current overall construction boom should continue for many months. Nonresidential construction is taking over where housing left off, thus, sustaining the total construction sector. Moreover, as interest rates continue to drop, mortgage rates included, an upturn again in housing starts in 1985 can be expected. Each 1 percentage point drop in the mortgage rate is worth about 150,000 single housing starts, and 60,000 to 70,000 multifamily starts. From an annual rate of 1.6 million per month late in 1984, housing starts should rise again in 1985, averaging about 1.8 to 1.9 million for the year as a whole.

WILL THE RECOVERY CONTINUE?

The question on most minds, of course, is, does the recovery have enough strength to continue into 1986 and beyond? The answer is yes, if renewed inflation and accompanying high interest rates are avoided through sound monetary and fiscal policy. High interest rates would stop business investment, put the brake on the strong automobile market, stop housing and business construction in their tracks, and abruptly throw the economy into recession.

Inflation

In 1984, consumer prices rose only 4.0 percent, and the GNP implicit price deflator, the broadest of all inflation measures, rose only 3.8 percent. These are marked improvements over the double-digit rates at the turn of this decade. Several key indicators suggest there is reason to be optimistic on the inflation front in 1985:

1. Wage increases will be moderate. The recent recession and high unemployment have tempered labor's demands, and workers prefer job security to large wage settlements. Also contributing to moderate wage settlements is a significant slowdown in cost-of-living adjustments in both union and nonunion wages (a case of disinflation feeding on itself). Some industries and firms are still taking wage cuts to preserve jobs.
2. Despite the best efforts of OPEC to reduce oil production, the worldwide oil glut should persist for a few more years, and help to hold down inflation.
3. Large food crops will continue to hold down food prices and the supplies of most other major commodities are also abundant.
4. Excess production capacity in most industrial markets (on a worldwide basis) will continue for some years.

5. Productivity, stemming in part from the recovery, will keep unit costs down, and beyond the recovery, innovation and more efficient production techniques and products will increase output per worker.

6. A prudent and stable monetary policy is assumed. This is the key element in the inflation fight and is discussed below.

Interest Rates

Interest rates are an elusive problem. Though difficult to forecast with any degree of confidence, short-term interest rates can be expected to move within a narrow band through 1985, seldom straying more than a couple of points up or down from where they are right now, but with a downward drift. This projection is based on the following reasons:

1. Inflation has been subdued, as discussed above.
2. Gross private savings rates—business and individual—have been on an uptrend the past year and are expected to continue on this path.
3. Business borrowing needs should be light to moderate as corporate profits and cash flows continue to finance the bulk of business expansion. Business did a great deal of belt tightening and cost cutting during the recession and the lowered break-even points paid off handsomely in raising corporate profits, and increasing efficiency of operations in 1983 and 1984. Undistributed profits, available for internal financing, rose 162 percent in 1983. While undistributed profits rose more slowly in 1984, they still rose by a solid 51 percent. Profits will likely rise only modestly in 1985, but corporate cash flow will continue to rise, due to good capital consumption allowances.
4. Future Federal deficits may not be as large as predicted by some due to greater than expected economic growth and aggressive deficit reduction efforts by the Administration and Congress in 1985 and 1986.

Monetary Policy

The underpinnings of sustained recovery in 1985 are low inflation and interest rate levels not much higher than they are today. The Federal Reserve System, through its monetary policy, will play a key role in sustaining the recovery.

Money supply is the oil that lubricates the machinery of the economy. Too little of it produces friction, which wears out the machinery. Too much of it floods the economy with inflation and shorts out the system.

Monetary policy is the major influence on shorter run cyclical changes, and monetary policy has been procyclical over the years. Cyclical variations in monetary policy have tended to overstimulate the economy during recoveries and over-restrain the economy during downturns, accentuating the cyclical nature of economic growth. Also, long-run growth is likely to be restrained if monetary policy is so unstable as to generate excessive uncertainty.

Any number of factors may contribute to cyclical disturbances. However, much evidence indicates that short-run changes in nominal spending generally result from changes in money growth rates during the preceding two or three quarters. Most recently, highly variable policies have made the economy acutely sensitive to changing monetary patterns, and economic activity seems to be responding with an even shorter lag of about a quarter.

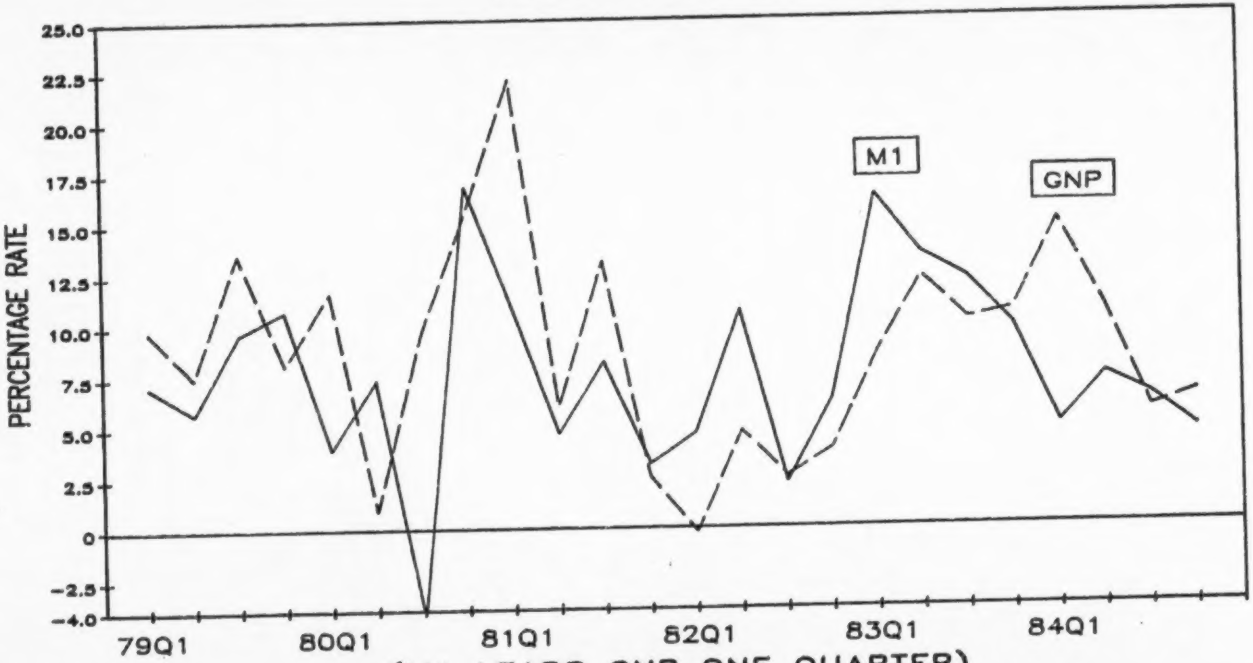
The pattern of volatile money growth creating volatile spending patterns is illustrated in Chart II.4. That chart shows M1 percentage change, and nominal GNP percentage change by quarter, plotted to have M1 lead GNP by one quarter. That is, the GNP plots are for the indicated quarter. The M1 plots are for the preceding quarter. In spite of protestation that institutional change, depository deregulation, and other special factors have disrupted the relationship between money growth and GNP growth, the relationship seldom has been more apparent than during the last five years. Especially noteworthy are the monetary contractions that contributed to the recessions of 1980 and 1981-1982 and the monetary expansions that facilitated the recoveries at the end of 1980 and during 1983.

CHART II.4

M1 AND NOMINAL GNP

QUARTERLY RATES OF CHANGE, SAAR

1979–1984



(M1 LEADS GNP ONE QUARTER)

Periods for M1, 78Q4–84Q3; GNP, 79Q1–84Q4

Source: Joint Economic Committee

The most ominous feature of Chart II.4 is the slowdown in money growth that occurred over the six months June to mid-November 1984. While a tight reign on monetary policy may have been necessary to prevent a resurgence of inflation generated by double-digit money growth between mid-1982 and mid-1983, the decline in M1 growth over the 12 months November 1983 to November 1984, and expecially over the six months June to November 1984, set a base for the economic slowdown that occurred in the third quarter of 1984 and the first quarter of 1985.

Fortunately, the Federal Reserve has eased some since mid-November 1984, suggesting that a good upturn in the economy can be expected in 1985.

While a generalized monetary expansion is not called for, there appears to be little inflationary danger in moving M1 growth up to the upper portion of the target range, to somewhere near 7 percent, and M2 to somewhere near 9 percent. It is recognized that the Federal Reserve has to walk a tightrope between inflation on one side and recession on the other. However, after leaning toward recession from June to November 1984, the time is appropriate to lean more toward moderate monetary expansion. This may, in fact, be happening now.

OUTLOOK FOR FUTURE ECONOMIC GROWTH

Assuming the Federal Reserve follows a course that makes monetary policy a contributor, not a drag, to continued noninflationary economic growth, the fundamentals of capital formation and productivity will determine the trend of the economy over the next several years.

Achieving a 4 percent growth in GNP for several years is highly probable if productivity can be returned to something a little better than its historic 2.5 percent growth path. Output per hour in the private business sector (including farming) rose by 2.7 percent in 1983 and another 3.2 percent last year. An average growth of 2.8 percent over the next several years is not unreasonable. Add to that a 1.2 percent growth in man-hours worked, and a solid 4 percent real GNP growth over the next several years is attainable. This would be adequate to continue a downward trend in the unemployment rate and would also make a contribution to deficit reduction.

In an opinion editorial in the August 29, 1984, Wall Street Journal, Professor John Kendrick notes that most of the factors that had a negative impact on productivity growth in the 1970's have been reversed. Most important, tax policy has been set on a growth course, instead of a drag course. There is more to be done on this. It is important that any tax reform act of 1985 or 1986 reflect the urgent need to continue to promote productivity. The key is to build on the Economic Recovery Tax Act of 1981 and move toward additional improvements in the after-tax rate of return on investment.

Other drags on productivity have been reversed. The deceleration in the inflation rate has increased the value of reported profits by removing distortions in depreciation allowances. Reduced inflation has also improved the efficiency of the market pricing system as an allocator of resources.

The costs of complying with social regulations have begun to level out as a percentage of GNP, after major increases in the 1970's. Moreover, some of the uncertainties, so destructive to incentives to invest, are being removed by regulatory reform. Economic deregulation is lowering prices in some portions of the transportation, communications, and financial sectors, and has increased competitive incentives for higher productivity.

Research and development spending, and the technological innovation that flows from it, are on the rise. R&D spending, as a percent of GNP, fell steadily from the mid-1960's until 1978, but is now rising at a fairly good pace. Returning to the 3 percent levels of 20 years ago would have very positive long-term economic effects. The ratio of R&D spending to GNP was 2.7 percent in 1984, up from 2.2 percent in 1978. While technological advancement is the least understood of all the factors affecting productivity, it is probably the chief long-term factor driving up productivity and economic growth. Several responsible studies show that productivity growth rates respond directly to changes in the growth of research and development expenditures. Also, congressional action late last year removing antitrust threats to joint R&D ventures should have beneficial effects.

The post-World War II baby boom crop, which swelled the ranks of inexperienced youthful workers in the late 1960's and in the 1970's, is now passing into productive working years.

Finally, there have been favorable developments in labor-management relations in the past several years as a result of keen foreign competition and the recessions of 1980 and 1981–1982. Not only have nominal wage-rate increases moderated significantly, but many new union contracts have reduced or eliminated restrictive work rules that hurt productivity. Both union and nonunion workers have, increasingly, participated in quality circles and other joint labor-management team efforts to improve productivity.

In summary, a 2.8 percent, or better, rise in productivity over the next several years is a realistic goal and, accordingly, real GNP growth of 4 percent per year is attainable.

In many respects, the recovery that still lies ahead can be related to the long period of stagnation and recession that preceded it. As noted earlier, the recovery is expected to extend to the outer limits of postwar recoveries—at least 50 months, into 1987. With sound monetary and fiscal policies, expansion through the decade is not beyond comprehension. After all, the economy expanded for nearly the full decade of the 1960's. Conditions are present for a similar performance in the 1980's.

Chapter III. FEDERAL BUDGET

Certainly one of the most important domestic issues facing Congress is controlling the growth of Federal spending to reduce budget deficits. Current spending trends are unsustainable.

There is a popular misconception that the Reagan tax cuts, not Federal spending growth, have caused the current deficit problem. The tax burden, measured as a share of national output, was higher in 1981 than in any year since 1945. Tax rates had to be cut in 1981 because excessive taxation had become a drag on economic growth. Even after the Reagan tax cuts, tax receipts have increased in every fiscal year except 1983, when they were depressed by recession. Federal revenues as a share of national output amounted to 18.6 percent in 1983 and 1984; this is in the same range as the post-World War II average of 18.5 percent. The Reagan tax cut was not a radical, drastic tax measure, it merely kept the total tax burden, as a percent of national output, near the post-World War II historical average.

A review of the facts conclusively demonstrates that the budget problem is caused by excessive Federal spending. Since 1963, total Federal outlays have grown almost sevenfold in nominal terms, and have more than doubled in constant (inflation adjusted) dollars. In 1983 alone, Federal spending surged $63 billion to $808 billion, representing 25 percent of total national output (GNP). This was the largest share of national output devoted to the Federal Government since 1946. By comparison, in the 1970's, Federal outlays averaged 21 percent of national output, still slightly above the 1945 to 1979 average of 19.9 percent. In 1984, the GNP share of Federal outlays declined to 23.8 percent due to a combination of fiscal restraint and strong economic growth. These budget trends are illustrated by the following table.

TABLE III.1.—FEDERAL BUDGET AND THE GROSS NATIONAL PRODUCT, [1] SELECTED YEARS, 1963–1984

[Dollar amounts in billions]

	Budget receipts		Outlays		Deficit	
	Amount	Percent of GNP	Amount	Percent of GNP	Amount	Percent of GNP
1963	$106.6	14.4	$111.3	19.3	$4.7	1.0
1968	153.0	18.4	178.1	21.4	−25.2	3.0
1973	230.8	18.4	245.7	19.6	−14.9	1.2
1978	399.7	19.1	458.7	21.9	−59.0	2.8
1980	517.1	20.1	590.9	22.9	−73.8	2.9
1981	599.3	20.8	678.2	23.5	−78.9	2.7
1982	617.8	20.3	745.7	24.5	−127.9	4.2
1983	600.6	18.6	808.3	25.1	−207.8	6.4
1984	666.5	18.6	851.8	23.8	−185.3	5.2

[1] Includes off-budget outlays.

Source: Office of Management and Budget.

Not only has the amount of Federal spending increased markedly, but its composition has also changed dramatically. Over the last two decades, the priority of Federal spending has been shifted from providing goods and services (including defense) to funding transfer payments, which include welfare programs, social security, and other social programs. In 1963, transfer payments comprised 28 percent, and defense outlays 48 percent, of total budget outlays. In 1984, transfer payments comprised 48 percent, and defense 28 percent, of total budget outlays, a complete reversal in just over two decades.

The explosion in transfer payments has driven the increase in Federal spending since the mid-sixties. In the last 20 years or so, Federal outlays for transfer payments multiplied thirteen-fold, from $31 billion in 1963 to $400 billion in 1984. Measured in constant (inflation adjusted) 1972 dollars, income transfers rose by a factor of 340 percent, from $41 billion in 1963 to $180 billion in 1984. Over this same period, constant dollar outlays for defense rose from $81.1 billion in fiscal year 1963 to about $90 billion in 1984; an increase of only 11 percent in over 20 years.

Not only have transfer outlays increased in absolute dollar amounts, but they also have grown as a share of the economy. In 1963, transfers amounted to 5.3 percent of GNP; by 1983 this had jumped to 12.3 percent. In 1983, more was spent on transfer programs than in any previous year (measured in either current or constant dollars), and transfers amounted to a larger share of national output than ever before. Rapid economic growth in 1984 reduced the GNP share of transfer payments to 11.0 percent. Contrary to popular perception, the amount of transfer and total domestic spending continues to grow, albeit at a slower rate.

"Uncontrollable" Federal Spending

The problems of fiscal control are compounded by the fact that much of the budget is relatively immune from annual adjustment. Restraint of entitlement programs, for instance, generally require changes in the authorizing legislation. Multiyear contracts, entitlement programs, and other open-ended programs, as well as interest payments on the national debt, are among the items classified as relatively uncontrollable. The expansion of uncontrollable spending over the last two decades means that a declining portion of the budget is routinely subject to review and, if Congress so wished, to control. The nature of much uncontrollable spending, particularly entitlements, creates strong expectations among client groups which are politically difficult to disappoint. Budget uncontrollables tend to be politically sancrosanct. Thus more and more of the budget becomes a perpetual spending machine, feeding on itself and making budget restraint almost impossible. It is no coincidence that the expansion of politically protected Federal spending has accompanied a deepening budget crisis. If permanent authorization of entitlement and other open-ended programs were ended, and they were made subject to routine periodic review and adjustment, the prospects for an improved budget outlook would brighten considerably.

In 1967, 57.0 percent of the Federal budget was classified as uncontrollable. By 1984, this had grown to 73.3 percent. This share is expected to expand to 76.6 percent in 1986. With about three quarters of the budget relatively free from annual adjustment, it is not surprising that the budget problem seems so intractable. One obvious reform is to require that reauthorization of these programs be made at regular intervals.

BUDGET OUTLOOK

According to the Office of Management and Budget (OMB), Federal outlays under current policy are projected to rise by $102 billion in 1985 to a level of $954 billion. This would be the largest annual rise in Federal spending in U.S. history, two and one-half times the increase in the previous fiscal year. This rapid increase in outlays would outpace the considerable $74 billion jump in receipts during 1985. Consequently, the higher outlay level will cause the deficit to expand by $28 billion to $213 billion in 1985. The OMB projects that spending growth will continue to outpace the increase in receipts during subsequent fiscal years so that the 1988 deficit could expand to $248 billion. The OMB current services baseline is displayed below in Table III.2.

TABLE III.2.—BUDGET OUTLOOK FOR FISCAL YEARS 1985 TO 1988 [1]

Budget component	1984 actual	1985 enacted	Baseline		
			1986	1987	1988
Budget totals:					
Revenues	$666	$741	$794	$864	$952
Outlays	$852	$954	$1,024	$1,109	$1,200
Deficit	−$185	−$213	−$230	−$246	−$248
Shares of GNP:					
Revenues (percent)	18.6	19.1	18.9	19.0	19.3
Outlays (percent)	23.8	24.7	24.4	24.4	24.4
Deficit (percent)	5.2	5.5	5.5	5.4	5.0
Spending and revenue growth over prior year:					
Revenues (percent)	11.0	11.3	7.7	8.8	10.2
Outlays (percent)	5.4	12.0	6.7	8.3	8.2

[1] Budget totals include off-budget outlays.

Source: Office of Management and Budget.

These figures show that the projected growing deficits in coming years are not the result of low revenue growth. According to OMB and the Congressional Budget Office, Federal revenues are estimated to rise by $60 to $90 billion each year over the next five years. The problem is that Federal spending is estimated to rise by an even higher range of $64 to $100 million per year.

In dealing with future deficits, the best strategy is to ensure continued economic expansion and to restrain Federal spending growth. Because the level of tax revenues will naturally increase as the economy expands, the key point is to let revenues catch up with the level of spending. This requires that Federal spending growth be held to a rate lower than revenue growth. A broad-based budget freeze on total government spending is one way to accomplish this objective.

If there are some intractable problems in reducing defense outlays or other Administration spending priorities, then Congressman Wylie suggests an option for funding such spending. He advocates raising excise taxes on alcohol, tobacco, and certain luxury items. This could produce substantial revenues because of the inelastic nature of demand for some of these products, and it could be done without touching income taxes.

BUDGET REFORM

The growth in the Federal spending share of GNP over the last two decades has outpaced that of the tax revenue share over the same period. While the Federal outlays share of GNP is near its all-time high of 25 percent, the share of Federal receipts has generally remained only slightly above its post-World War II average of 18.5 percent. Thus, the growth of Federal spending has burdened the economy with large deficits in recent years. In fact, the Federal budget will have been in deficit 25 of the last 26 fiscal years (counting fiscal year 1985). The "institutionalization" of the deficit problem suggests that an institutional solution is urgently needed. Though Congress now has better budget information than was often the case in the past, the 1974 Budget Act has obviously failed in a primary objective of controlling Federal spending and forcing the Government to live within its means.

Spending Bias of the Legislative Branch

For most of U.S. history, the principle that Federal spending should not exceed tax receipts was violated only in exceptional circumstances, such as war, and acquired such universal acceptance that it was referred to as part of our unwritten constitution. This maxim of fiscal responsibility was long respected by both parties in Congress. In recent decades, however, some economists and politicians extolled the virtues of deficits to counteract recessions. Intentional creation or expansion of the deficit during recession was seen as the basis of countercyclical macroeconomic policy. The growing prestige of this view provided the perfect excuse to abandon altogether traditional fiscal discipline.

What ensued was comparable to opening Pandora's box. The natural tendency of Congress to increase constituent spending was unshackled. Since the 1960's, the United States has run deficits in good times as well as bad. In this new environment, government discipline in budget matters vanished.

Currently, the political process contains a strong bias toward increased Federal spending. Powerful special interests successfully pressure legislators in support of pet programs. While the ostensible benefits of these programs are highly concentrated, the costs are diffused among all taxpayers. The intensity of special interest pressure often overwhelms the will of Congress to restrain Federal spending. Because the cost to each taxpayer of each item is relatively small, there is little motivation to organize and exert equal pressure and resources against the special interests.

The Founding Fathers were familiar with the danger posed by special interest coalitions, which they referred to as "factions," and sought to limit their influence by constitutional means. In the famous Federalist Paper Number Ten, James Madison pointed out that "to secure the public good and private rights against the danger of such a faction, and at the same time to preserve the spirit and the form of popular government, is then the great object to which our inquiries are directed."

Then, as now, the institutional structure within which policymakers operate governs their choices. The rules underlying the institutional order preclude certain courses of action, and may make some other actions more difficult. For example, the U.S. Constitution limits the Congress' and State legislatures' powers by laying down certain principles that may not be violated. These constitutional proscriptions are enforced by the Supreme Court's exercise of judicial review, through which unconstitutional legislation may be struck down. In a less formal way, the rules of legislative bodies are designed to provide a framework within which majority rule operates. Often these rules are intended to make majority decisions more deliberate or to protect the rights of minorities.

The existence of such rules may or may not be sufficient to accomplish their purpose. However, the absence of rules where needed can lead to costly or irrational decisions. For example, the lack of a strong connection between the costs and benefits of congressional spending makes it difficult to rationally evaluate the level and composition of Federal outlays. The many benefits of the various proposed programs or funding levels are considered independently of the means of funding these programs. This distorted perspective has been described as a fiscal illusion.

Obviously, the practice of voting first on the funding level of an expenditure, and only later worrying about how to finance Federal outlays, and then only in the aggregate, will tend to lead to a higher level of Federal spending than would otherwise be the case. Not only is the cost deferred and thereby partially hidden, but there is always the prospect of funding constituent programs at the expense of other groups. While spending may or may not yield some benefit, taxation will always yield an economic cost.

Furthermore, when considered at a higher level, there is no rule limiting the level of total budget outlays to available tax receipts. Consequently, it should be no surprise that Federal spending has skyrocketed in recent decades. The establishment and authorization of modest domestic programs during the 1960's, without adequate consideration given to their future costs, has led to a dramatic expansion of such programs beyond anything their proponents or anyone else thought possible or desirable. The need to contain the expansion of these domestic programs is now widely accepted.

The fiscal illusion is a result of an asymmetry in decisionmaking. It would be removed if funding measures for programs were linked to earmarked receipts so that the costs and benefits of each item could be considered on its merits. The absence of any such restriction, even regarding the budget totals, is an institutional defect which distorts decisionmaking and leads to a severely unbalanced budget policy. Consequently, measured by results in budget matters, the Congress is less than the sum of its parts. This situation has generated a number of innovative proposals for institutional reform to improve the consideration of program costs.

The Balanced Budget Amendment

The Balanced Budget/Tax Limitation Constitutional Amendment is one needed reform. Section 1 of the Amendment requires Congress to adopt a balanced budget plan prior to each fiscal year. Congress could violate this balanced budget rule by a three-fifths vote in each Chamber. Otherwise, under this section, actual outlays would not be permitted to exceed planned outlays. However, a deficit resulting from a revenue shortfall (for example, resulting from recession) would be tolerated. Section 2 stipulates that the rate of planned revenue growth should not exceed the growth rate of national income, unless a majority of *all* Members of both Houses of Congress pass a tax bill that has become law. Since the level of Federal receipts and spending normally must balance, Section 2 also indirectly places a limit on the growth rate of Federal outlays.

This Amendment would reestablish the constitutional norm of budget balance respected through most of our Nation's history. Once in place, it would limit the amount of Federal spending to the level of projected tax receipts, thus removing the fiscal illusion which encourages congressional funding of programs without much thought given to how they are to be financed. This would result in greater scrutiny of each item of expenditure to determine whether its benefits outweighed the costs imposed by additional taxation. Although deficits could still occur if recession depressed revenues, or by a super-majority vote of each House of Congress, at least the institutional bias toward deficit spending would be terminated. Despite the fact that partisans like to blame the President for excessive Federal spending and deficits, the Constitution clearly charges the Congress with the primary responsibility for budget decisions. Article 1, Section 8, empowers Congress to "lay and collect Taxes . . ., to pay the Debts and provide for the common Defense and general Welfare of the United States." Section 9 further stipulates that "No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law." This constitutional mandate given Congress for making taxing and spending decisions defines the responsibility of Congress for setting budget policy.

A total of 39 States have constitutional provisions limiting their ability to incur budget deficits. In addition, eight other States have statutory constraints on deficit spending. Thus, a total of 47 States have some form of deficit limitation.

Critics oppose the Amendment because they contend it would "handcuff" the Congress and limit its power. There is some truth in this; the intent of the Amendment is to limit the fiscal discretion of Congress. However, this is perfectly consistent with the nature and purpose of the Constitution. As James Madison pointed out in the Federalist Paper Number Fifty-one, "If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls of government would be necessary." In the absence of either situation, the Constitution was and remains needed to set limits and controls on government. The Balanced Budget Amendment merely applies this sound principle to fiscal policy.

Critics also argue that incorporating any element of economic policy into the Constitution is improper. Apparently these critics are unfamiliar with sections of the Constitution regarding delegation of taxing and spending powers, property rights, issuance of bills of credit by the States, the 16th amendment, and other provisions. The proposed Amendment is completely within the spirit of the Constitution. No less an authority than Thomas Jefferson suggested that an amendment "taking from the government the power of borrowing" would help "the reduction of the Administration of our government to the general principles of its constitution." Clearly, he saw this as a reform that would improve the proper functioning of the Constitution.

Reform of the Budget Process

Most budget experts agree that the major problem with the current Budget Act is its lack of firm enforcement provisions. It is simply too easy to subvert budget resolutions through Budget Act waivers, intentional underestimation of spending levels resulting in routine supplementary appropriations, and off-budget spending. Furthermore, the current budget process is unwieldly and absorbs an inordinate amount of time. Thus, some streamlining of budget procedures is also desirable.

The Deficit Reduction Act.—On January 3, 1985, Senator James Abdnor introduced S.57, the Deficit Reduction Act. This legislation would amend the Congressional Budget Act to require Congress to reduce the current deficit by 15 percent in each of the three fiscal years following enactment, and 10 percent thereafter. Thus, over three years, the deficit would be almost halved; in nine years, it would be entirely eliminated. In the first two years, at least two-thirds of the deficit reduction would have to come from spending restraint, thereafter at least half of the deficit reduction would have to come from the outlay side of the budget. If Congress did not follow the deficit reduction mandated by the Act, the President would be given sufficient impoundment power to effect the targeted deficit levels. Strong safeguards would be provided to prevent any potential abuse of the expanded impoundment power by the executive branch. Under the Act's provisions, the President could not cut outlays of any programs by more than 10 percent, unless authorized to do so by the Congress.

This Act would make a great contribution to solving the budget problem by committing Congress to a realistic and gradual schedule of deficit reduction. Although more dramatic and harsher reforms might be envisioned to achieve the same objective over a shorter time period, the Deficit Reduction Act represents a reasonable compromise. Moreover, this Act complements other deficit reduction efforts by improving the procedural framework of the Budget Act. The Abdnor budget reform commits the Congress to deficit reduction and provides the needed institutional changes; it does not specify the budget functions to be adjusted by subsequent budget and appropriations measures. The Abdnor reform proposal is necessarily inflexible in setting the ultimate objective; however, it is quite flexible regarding the means available to achieve that objective. Hence, very different budget strategies could be considered by the Congress within the confines of this reform. Backstopping the reform is the restoration of more balance between the legislative and executive branches in budget making. Should the Congress prove unwilling or unable to satisfy the terms of the Deficit Reduction Act, the President could take the required actions. Nonetheless, the existence of such a possibility should be sufficient to reinforce the determination of Congress to comply with the deficit reduction targets.

Line-Item Veto.—As budget outlays and deficits have ballooned in recent years, proposals to grant the President line-item veto authority have gathered broad support. This power would permit the President to strike out spending for specific programs without having to veto an entire appropriations bill. By giving the President line-item veto authority, the Congress would be shifting significant budget power to the executive branch. This reform could necessitate an amendment of the Constitution.

A line-item veto could be an effective tool to restrain spending growth because of the nature of appropriations measures. In the appropriations process, each of the 13 appropriations measures can be packaged to attract needed political support by including sweeteners for targeted constituencies. Through "logrolling," a sufficient number of votes for an appropriations measure can be obtained, but funding then becomes a function of political expediency instead of a rational allocation of priorities. In the end, not only do these spending measures include unneeded items, but they are often used to attract support for excessive funding of legitimate programs. If asked to vote on the merits of each of these special programs, Congress might well vote many of them down. But when they are included in an overall appropriations bill, they go sailing through. Thus, programs which could not survive if they had to stand or fall on their own merits are funded through this defect in the overall appropriations process. This results in the excessive level of funding which most Members of Congress oppose, but that is paradoxically a consequence of collective congressional decisions.

A line-item veto would correct this defect in our representative institutions by providing a method of eliminating unnecessary programs. Perhaps more importantly, the mere existence of this authority could discourage overloading the appropriations measures with special interest programs.

OMNIBUS BUDGET REFORM

A number of proposals have been made to establish a two-year budget cycle or to otherwise restructure the congressional budget process. For example, the Federal Budget Reform Act, introduced by Senators Roth and Evans on January 3, 1985, would implement several changes. It would extend the current annual budget process into a biennial system. Fiscal years would begin on January 1 of even numbered years. The first session of Congress would be used to make budget decisions, and oversight would be conducted in the second session. The annual budget process is very cumbersome and requires a great deal of time to implement; this reform would streamline the process and make it less time consuming. Many outlays are determined in advance (e.g., the interest on the national debt, entitlement allotments, etc.), and it is repetitive to review them annually. By making these decisions every other year, more time would be afforded to Members of Congress to meet their other responsibilities. This proposal increases the amount of time available to evaluate budget outlays and make needed policy changes. Two-year planning would add stability to the system by decreasing uncertainty for Federal agencies and State governments who count on accurate long-term forecasts of Federal appropriations in order to conduct their own planning.

The biennial budget process currently being considered also requires a single binding budget resolution which would be followed within 60 days by enactment of a reconciliation bill. The annual budget process strains authorization timing, forcing decisions to be made with a very limited amount of time for consideration or debate, and quite often delays and supplemental funding become necessary. Having a first, second, and at times, third budget resolution is a very repetitive process and Members of Congress are often able to barely "push through" programs close to deadline time. The current use of continuing resolutions, which would be eliminated under the two-year plan, usually results in increased outlays for the program involved and often leads to confusion for agencies, State governments, and policymakers because appropriation amounts change over the course of the year. Introducing a single binding resolution would eliminate much of the repetition and upward pressure of Federal spending that the current process allows.

Another change that would be implemented by the Federal Budget Reform Act would be a requirement for a rollcall vote of two-thirds majority of the Congress for any revisions to a budget resolution. Excessive legislative spending could be effectively reduced by making it more difficult for Congress to alter decisions once they have been made. This reform would encourage use of reconciliation to address budget problems.

Finally, the proposal calls for the replacement of the current 13 appropriations bills by a single omnibus appropriations bill. Combining the bills in this manner could make revenue logrolling between special interests in Congress very difficult, and would, therefore, reduce the overall escalating level of Federal spending.

Though the changes that would be implemented by the Budget Reform Act are directed at parts of the annual budget process that are badly in need of procedural reform, there are certain disadvantages associated with the new measures. The most obvious criticisms of the suggested two-year budget process are that it could bind Congress to appropriations based on premature economic assumptions, and the flexibility of Congress to accommodate unforeseen problems would be hampered.

Two years is a relatively long period for the economic outlook to go unchanged. In light of recent difficulties of economic forecasting, the impact of economic assumptions under a two-year budget planning system could become more disruptive of budget planning. Inaccuracies in predictions would have magnified consequences that could necessitate sudden corrections.

On the other hand, the two-year budget planning system would constrain the ability of Congress to react to changed circumstances as well as restrain the tendency for spending to exceed revenues. The relative value of greater control over spending has to be weighed against the reduced ability to correct errors in estimation in midcourse. The dilemma is perhaps not as difficult as it might seem, however, if we reject the notion that the Federal Government must stand ready to "find-tune" the economy. Congress has shown no great ability to enact new fiscal policy measures, such as job-creating public works programs, with any timeliness. Thus, the idea that congressional discretion is needed to fine-tune the economy is based on the faulty promise that Congress is able to fine-tune the economy in the first place.

Although larger forecast errors might be present in a two-year budget system, it would not necessarily lead to worse budget policy. The executive branch agencies that administer programs authorized by Congress have no hesitancy to seek supplemental appropriations if the initial appropriation assumptions are too low, and, if initial assumptions are too great, it should be possible for the Office of Management and Budget to recommend a rescission in the authorized program levels.

Finally, presenting the President with only one resolution to veto could severely restrict his flexibility and authority to manage the executive branch. Consequently, the desirability of line-item veto authority could become even greater.

Deficit Reduction Commission

To deal with the immediate budget problems while the foregoing longer run solutions are being worked out, Congressman Wylie suggests the creation of a bipartisan deficit commission. Legislation to establish such a commission, called the National Commission on Federal Budget Deficit Reduction, was introduced on January 3, 1985, by Congressman Wylie as H.J. Res. 9. The Commission would consist of 15 members, five appointed by the President, five by the Senate Majority Leader, and five by the Speaker of the House. The Commission must report its recommendations to the President and Congress within six months of enactment of the resolution. Similar to the presidential commission formed to break the deadlock on social security reform, the bipartisan National Commission on Federal Budget Deficit Reduction would bring together respected, qualified people from both parties—people in and out of government, including credit-sensitive industries, to forge a bipartisan package of compromises to reduce our deficits.

The Commission would review fiscal and monetary policy effects on structural Federal budget deficits and the impact which these deficits have on employment, capital formation, and the vigor and viability of the economy. It would assess how much government we really want or can afford, examine built-in devices to counter congressional spending bias, and analyze options for bringing deficits down.

The Commission can serve as a political "heat shield" and can develop budget recommendations in a detached, objective way. A polarized Congress finds it very difficult to deal with taxing and spending issues. Everyone has his own private list of what should go into a deficit reduction package, and no lists agree. A commission could resolve this stalemate.

CONCLUSION

The Federal budget is still out of control. Close scrutiny of all spending programs is needed in the current budget cycle; no part of the budget should be exempt from review. A two-pronged attack on Federal spending growth offers the best prospect for success. First, some plan for broad-based Federal spending restraint in FY 1986 must be considered by the Congress to contain Federal outlays, and to reduce the deficit in the next several fiscal years. Second, basic institutional reform should be used to increase congressional incentives for spending restraint and deficit control. Unfortunately, some of these reforms would require amendment of the Constitution, and as such represent only a possible future solution. The Abdnor budget reform described above has the merit of mandating budget control and deficit reduction in both the short and long run. This reform would greatly enhance the chances of other desirable measures to restore fiscal responsibility.

Chapter IV. TAX REFORM

It is common knowledge that public disenchantment with taxation is broad and deep. The Federal income tax is held in especially low regard. According to the Advisory Commission on Intergovernmental Relations (ACIR), their most recent poll found that 36 percent of Americans viewed the Federal income tax as the worst of all forms of taxation—Federal, State, and local. Consequently, proposals for tax reform fall on receptive ears. The public believes that the current Tax Code should be changed to make it more fair, simple, and efficient. Few tax experts would dispute this appraisal. The main barrier is overcoming the special interests who benefit from the provisions of the current Tax Code.

Aside from the problem of fairness, the current Tax Code is defective on economic grounds. Despite the progress under the Economic Recovery Tax Act in bringing down excessive marginal tax rates, much remains to be done. High marginal tax rates are still a formidable impediment to saving, investment, risk taking, and economic growth. It is encouraging to note that current tax reformers see this as the main problem to be corrected, whereas only a few years ago many did not. This evolution of tax policy provides a solid foundation for efforts to reduce the tax barriers to productivity gains, economic growth, and full employment.

Another economic problem with the current system is its discriminatory treatment of various activities. Tax provisions which favor one form of investment over another or otherwise alter decisionmaking are generally economically inefficient. Not only are certain industrial sectors harmed by such discrimination, but the economic welfare of the whole community is lowered by a wasteful allocation of resources. We shall return to this issue again.

THREE CRITERIA FOR TAX REFORM: ECONOMIC EFFICIENCY, EQUITY, AND SIMPLICITY

The three primary criteria for tax policy are economic efficiency, equity, and simplicity. Much controversy in tax policy is created by how these criteria are balanced in any particular tax plan.

Economic efficiency requires that the imposition of a particular tax has only a minimal impact on decisionmaking and resource allocation, relative to what would otherwise be in the absence of the tax. The term neutrality, often used in this context, means that the tax does not alter the choice between saving and consumption, labor and leisure, or one good or service and another. Thus, a neutral tax is one which does not alter the price of one product or activity relative to the price of an alternative. Though good tax policy cannot improve economic welfare from what it would be in the absence of taxation, it can be structured in such a way that its interference with the economy is minimized. This ensures that market forces can operate to maximize allocative efficiency and economic welfare.

Equity is another important criterion of tax policy. One of the factors causing many Americans to feel the current Tax Code is unfair is the belief that similarly situated taxpayers are not treated equally. Thanks to the various preference items, two taxpayers earning the same income may incur widely divergent tax liabilities depending on how successfully they can exploit tax loopholes. The opposite of this situation is one of horizontal equity, under which similarly situated taxpayers pay roughly the same amount of tax.

Another commonly applied principle of taxation is "vertical equity." This usually means that people in differnt income classes should be taxed according to their "ability to pay." The problem is that there is no clear or universally accepted definition of this concept. The inability to measure and compare the marginal utility of income of different persons renders the "ability to pay" notion imprecise. Though some degree of progressivity can be advanced on practical or normative grounds, there is no clear, objective formula to apply in designing the rate structure. Any argument in favor of one degree of progressivity can be used to support virtually any other level of progressivity.

Simplicity is now a popular criterion of taxation. The Tax Code should be straightforward enough to be understood by citizens as both taxpayers and voters. While much tax law is unavoidably complicated, unnecessary complexity and special measures should be avoided as much as possible. Popular dependence on tax practitioners is one expression of the confusion and frustration many experience in attempting to complete their own tax returns. Consequently, tax simplification has attracted broad-based support.

AGENDA FOR TAX REFORM

Choosing the Appropriate Tax Base

In recent years, consideration of the most desirable tax base has been hotly debated. The discussion centers on two potential model alternatives: a consumption tax base or a comprehensive income tax base. The current so-called income tax system actually incorporates elements of each alternative tax base. The hybrid nature of the current code reflects the unwillingness of policymakers to choose a single, consistent tax base, perhaps because each has advantages and disadvantages.

Consumption Versus Income Taxation.—The concept of consumption taxation is quite simple: saving should be excluded from the tax base. Though there are a variety of ways to structure a consumption tax, they all share the exclusion of saving as a common feature. Consumption taxation can take the form of a Value Added Tax (VAT), retail sales tax, or a consumed income tax.

The chief advantage of consumption taxation is that it is far more neutral than income taxation. Under consumption taxation, relative prices are unaffected and allocative efficiency unhampered by distortion arising from the differential taxation of saving and consumption under an income tax. However, any income tax, by taxing both amounts saved and the returns on such saving, taxes saving twice and thus increases the price of saving relative to consumption. As the Brookings Institution publication Economic Choices 1984 puts it, the income tax not only distorts the composition of saving but also "discourages people from providing for future consumption needs. When a person earns a dollar, he must decide whether to consume it now or to save it for later consumption or bequest. If there were no taxes, this decision would be based on each person's present wants and best guess about future wants and on the rate of return on savings. The personal income tax distorts this decision, because the return to saving is taxed. As a result, the income tax increases the cost of future consumption or, in other words, reduces the rewards to saving." The natural result is to encourage consumption and discourage saving and investment. Because an income tax base alters decisionmaking more than a consumption tax, it is less economically efficient.

By introducing the concept of lifetime income, it also becomes clear that income taxation is inequitable. All other things being equal, under an income tax the timing of saving and consumption can generate different tax results. A person who uses his endowment to save early in life will pay more taxes during a lifetime than a similarly situated person who spends his endowment early in life and saves only later. Though the two individuals may begin with equal endowments, the double taxation of saving ensures that the saver will incur a greater tax liability over his or her lifetime. This violates the principle of horizontal equity.

Another ramification of consumption tax neutrality is the treatment of business investment. Business saving in the form of investment would be deductible for the same reason personal saving would be deductible—to avoid the double taxation of saving. This tax treatment is required to prevent a rise in the price of saving relative to consumption after the imposition of a tax. As a 1977 Treasury study points out * * * "allowing immediate deduction for tax purposes of the purchase price of an item that will be used up over a period of years (i.e., immediate expensing of capital investments) is equivalent to consumption tax treatment of investment income because it allows the full deduction of savings; thus, accelerated depreciation approximates the consumption tax approach." Unused tax benefits could be carried forward or backward without limit. Although the current Accelerated Cost Recovery System causes some intersectoral distortion, it does provide some benefits of consumption taxation in the sense that some investments qualify for treatment approaching expensing.

The consumption tax base offers several important advantages over the income tax base. However, the transitional costs of this reform could be significant. In any event, we will now consider the structure of model consumption and income tax systems.

Blueprints for Basic Tax Reform

In 1977, the U.S. Treasury released its Blueprints for Basic Tax Reform, prepared at the request of then Treasury Secretary William Simon. Since its release, it has been widely hailed as a classic of tax policy literature. The Blueprints for Basic Tax Reform presents an extensive economic and administrative analysis of tax reform options, focusing on a model comprehensive income tax and a model cash flow consumption tax. Because of the influence the Blueprints has had on the tax reform debate, and its construction of conceptually pure alternative model tax systems, it is worthwhile to briefly consider this study below. Both the comprehensive income tax and cash flow consumption tax models will be described.

Comprehensive Income Taxation

Under this system, income would be conceptually defined as consumption plus changes in net worth. In practice, virtually all means of financing these elements of income would be included in the tax base. A consistent application of the comprehensive income tax principle would introduce radical changes. Most of the numerous tax deductions, exclusions, exemptions, and other preference items would be eliminated. Almost all cash and in-kind contributions to income would be subject to taxation.

The tax base would be broadened to embrace State and local bond interest, State and local sales and gasoline taxes (nonbusiness), employer-provided fringe benefits, medical expenses, charitable contributions, uninsured casualty losses, accrued interest earnings on pension funds, unemployment compensation, and capital gains. Furthermore, means-tested as well as non-means-tested government cash transfer payments such as veterans benefits and pensions, Aid to Families With Dependent Children, Supplementary Security Income, OASI benefit payments, workers' compensation, and black lung benefits would all be taxable.

Comprehensive income taxation as a goal, in and of itself, has long been an objective of some tax reformers. It must be pointed out that, in the Treasury's model tax system, the base broadening is coupled with an across-the-board reduction in marginal tax rates. The recommended tax schedule (adjusted for inflation) is shown below.

TABLE IV.1.—COMPREHENSIVE INCOME TAX

[Basic Exemption: $2,800 Per Return Plus $1,750 For Each Taxpayer and Dependent]

Comprehensive income bracket (Dollars)	Marginal tax rate (Percent)
Joint returns:	
0 to 8,050	8.0
8,050 to 70,000	25.0
Over 70,000	38.0
Single returns:	
0 to 4,900	8.0
4,900 to 70,000	22.5
Over 70,000	38.0

Source: Blueprints for Basic Tax Reform, 2nd Edition.

Under this model plan, reform of business taxation is no less dramatic. The basis for depreciation would be adjusted for inflation. Corporate and personal income taxation would no longer be separate, but would be integrated. Distributed dividends would not be taxed at the corporate level. Retained corporate income would be allocated to shareholders and subjected to taxation at the appropriate personal marginal tax rate. By eliminating the double taxation of corporate income, the tax reform would remove one of the most troublesome components of the current tax system.

The Blueprints proposal to eliminate a separate corporate income tax might sound unreasonable, if not outrageous, to many. Superficially, at least, it would appear that the corporate tax burden might be shifted onto low- and middle-income taxpayers. However, as the Blueprints points out:

> A separate tax on corporations is not consistent with an ideal comprehensive income tax base. Corporations do not "consume" or have a standard of living in the sense that individuals do; all corporate income ultimately can be accounted for either as consumption by individuals or as an increase in the value of claims of individuals who own corporate shares. Thus, corporations do not pay taxes in the sense of bearing the burden of taxation. People pay taxes, and corporate tax payments are drawn from resources belonging to people that would otherwise be available to them for present or future consumption.
>
> It is difficult, however, to determine which people bear the burden of corporate tax payments. In a free enterprise system, goods are not produced unless their prices will cover the costs of rewarding those who supply the services of labor and capital required in their output as well as any taxes imposed. The corporation income tax thus results in some combination of higher relative prices of the products of corporations and lower rewards to the providers of productive services, and it is in this way that the burden of the tax is determined. In spite of many attempts, economists have not succeeded in making reliable estimates of these effects, although a substantial body of opinion holds that the corporation income tax is borne by all capital owners in the form of lower prices for the services of capital.
>
> The two major advantages of integrating the corporate and personal taxes are that (1) it would eliminate the incentive to accumulate income within corporations by ending the double taxation of dividends and (2) it would enable the effective tax rate on income earned within corporations to be related to the circumstances of individual taxpayers.

Consumption Taxation

The idea of consumption taxation goes back at least as far as Thomas Hobbes, who argued that people should be taxed on what they withdrew from total wealth, instead of what they contribute. The economic distortions caused by the double taxation of saving under an income tax has led many economists from across the political spectrum to support some form of consumption tax reform. In recent years, an increasing number of economists have endorsed this approach. Although a variety of forms of consumption taxation exist, here we will concentrate on the type of "consumed income," or expenditure tax, described in the Blueprints for Basic Tax Reform.

The Cash Flow Tax

This form of consumption tax offers many advantages. It is relatively simple, flexible, and easy to administer. Under a cash flow tax, the complicated problems arising from defining a comprehensive income base, adjusting capital income for inflation, and calculating corporate taxation would not exist. The basic principle would exclude saving from the tax base and thus prevent the tax from altering the price of saving relative to consumption. Under the cash flow tax model, the taxpayer would add the inflow to the taxpayer of cash from all sources, and deduct cash outflows used for qualifying forms of saving and investment. The remainder, net of allowable deductions, exemptions, and other preference items, would be the consumption base.

The tax deductible saving and investment would be channeled through special "qualified accounts" set up at banks, savings and loan associations, brokerage firms, and other institutions. Withdrawals from the qualified accounts would be included in the tax base. Unlike the situation under an income tax, tax liability would not vary with patterns of consumption and saving over the course of a lifetime. Taxpayers who choose to save relatively early in life would not incur a higher lifetime tax liability compared to taxpayers who choose to save late in life.

This particular model tax would repeal deductions for charitable contributions, medical expenses, property taxes, casualty losses, retirement benefits from pension funds, and any type of consumed income.

This form of taxation would require special treatment of borrowing. Net borrowings would be included in the tax base and taxed as consumption. It would be practicable to include many kinds of loans in the tax base in the same year the funds were borrowed. However, in recognition of the lumpiness of some large loans, especially for consumer durables such as houses and cars, an alternative tax treatment could be chosen. A down payment for a house, for example, could be saved in a non-qualified account, and then spent without causing tax liability. The mortgage would not be included in the tax base, but subsequent cash outflows in the form of mortgage payments on principal and interest would not then be tax deductible. This alternative treatment of borrowing, at taxpayer election, is administratively simple because neither the initial saving for the down payment nor the mortgage payments receive special tax treatment. The individual tax schedule would be as follows:

TABLE IV.2.—CASH FLOW TAX

[Basic Exemption: $2,625 Per Return Plus $1,400 For Each Taxpayer and Dependent]

Cash flow bracket (Dollars)	Marginal tax rate (Percent)
Joint returns:	
0 to 9,100	10
9,100 to 52,500	28

TABLE IV.2.—CASH FLOW TAX—Continued

[Basic Exemption: $2,625 Per Return Plus $1,400 For Each Taxpayer and Dependent]

Cash flow bracket (Dollars)	Marginal tax rate (Percent)
Over 52,500	40
Single returns:	
0 to 5,600	10
5,600 to 52,500	26
Over 52,500	40

Source: Blueprints for Basic Tax Reform, 2nd Edition.

Under this model tax, corporate taxation would be eliminated. Corporate dividends distributed to shareholders would receive appropriate tax treatment depending on whether saved or consumed. Since corporations are not consumers, retained earnings and other corporate proceeds would not be taxed. All the complications of a separate corporate tax would disappear.

The two Blueprints models previously discussed might well be unrealizable in the legislative process. However, they are very useful as touchstones for tax policy. The Blueprints has had a major impact on the direction of tax debate ever since its publication, and provides a good perspective for the evaluation of subsequent tax reform proposals.

Incremental Reform in Japan

While sweeping consumption tax reforms may have considerable appeal, Japanese tax policy illustrates how easy it is to advance in this direction using only a piecemeal approach. Over the last three decades or so, the Japanese have introduced a variety of schemes, particularly in their personal income tax, to extend consumption tax treatment to saving and investment. These measures were introduced by the Japanese Government with the intent of increasing saving and investment. These savings incentives, along with other factors, have indeed contributed to the high personal savings rate of Japan.

One of the forms these incentives takes is the exclusion of interest earned on most depository accounts, so long as the principal is about $12,000 or less. Furthermore, though three such accounts are legally permitted, the authorities do not vigorously enforce the limit. This officially condoned tax evasion is so widespread that it has been estimated that the number of such tax favored accounts is about twice the entire population of Japan. Furthermore, a special tax rate is available at taxpayer election for investment income. Currently, this rate is 35 percent, but it has been much lower in previous years. Another interesting feature is the virtual exclusion of capital gains from individual income taxation. All these items tend to encourage saving, investment, and risk-taking.

Current Treasury Tax Reform Plan

To many, the ideas contained in the recently released Tax Reform for Fairness, Simplicity, and Economic Growth may sound new and innovative. This package couples a compressed and lower individual tax schedule with a broadened tax base, along with corporate tax changes. This new plan is not much more than a potpourri of ideas entertained by various tax reformers over the course of many years. In the area of individual taxation, it bears more than passing resemblance to the comprehensive income tax model published as part of the Blueprints study in 1977. Like the Blueprints, the current Treasury plan would broaden the income tax base and compress the individual marginal tax rate schedule into three graduated rates, though changed to 15, 25, and 35 percent. The following Table IV.3 shows how the current rate structure would be changed.

TABLE IV.3

Comparison of Tax Rates Under Current Law and Proposal for 1986

Single Returns			Head of Household Returns			Joint Returns		
	Marginal tax rate			Marginal tax rate			Marginal tax rate	
Taxable income	Current Law 1/	Proposal	Taxable income	Current Law 1/	Proposal	Taxable income	Current Law 1/	Proposal
Less than $2,510	0		Less than $2,510	0		Less than $3,710	0	
2,510 - 3,710	11	0	2,510 - 4,800	11	0	3,710 - 6,000	11	0
3,710 - 4,800	12		4,800 - 7,090	12		6,000 - 8,290	12	
4,800 - 7,090	14		7,090 - 9,490	14		8,290 - 12,990	14	
7,090 - 9,280	15		9,490 - 12,880	17		12,990 - 17,460	16	
9,280 - 11,790	16	15	12,880 - 16,370	18	15	17,460 - 22,040	18	15
11,790 - 14,080	18		16,370 - 19,860	20		22,040 - 26,850	22	
14,080 - 16,370	20		19,860 - 25,650	24		26,850 - 32,630	25	
16,370 - 19,860	23		25,650 - 31,430	28		32,630 - 38,410	28	
19,860 - 25,650	26	25	31,430 - 37,210	32	25	38,410 - 49,980	33	25
25,650 - 31,430	30		37,210 - 48,780	35		49,980 - 65,480	38	
31,430 - 37,210	34		48,780 - 66,130	42		65,480 - 93,420	42	
37,210 - 45,290	38		66,130 - 89,270	45		93,420 - 119,390	45	
45,290 - 60,350	42	35	89,270 - 118,190	48	35	119,390 - 117,230	49	35
60,350 - 89,270	48		118,190 or more	50		177,230 or more	50	
89,270 or more	50							

Office of the Secretary of the Treasury
Office of Tax Analysis.

November 26, 1984

1/ Estimated.

Source: U. S: Treasury Department.

Many of the same deductions targeted by the Blueprints model are also limited or repealed by the new Treasury plan. Though not quite as "pure" as the 1977 model reform, the lastest proposal does sweep away or modify many popular tax preferences. However, it does maintain—and even extend—certain features of the current Tax Code which have extended consumption tax treatment to saving and investment. This is especially true of the higher deduction allowed for contributions to IRA accounts.

Deductions for charitable contributions, medical expenses, second home mortgage, consumer interest, and business personal expenses would be limited, and those for State and local taxes and two-earner families would be repealed. Unemployment compensation and workers' compensation would be subject to tax. On the other hand, the cap on IRA-contributed deductibility is raised and other retirement items are preserved. The personal exemption is increased to $2,000. Indexation of the personal exemption and tax brackets is preserved.

It is in the area of corporate taxation that the current Treasury plan departs most from the 1977 Blueprints comprehensive income tax. Instead of full integration of personal and corporate taxation, the 1984 plan retains the separate corporation income tax, albeit with a 50 percent dividend deduction. Some of the problems noted by the 1977 study would remain. Furthermore, instead of extending partnership tax treatment to corporations, as in the 1977 plan, the current proposal seeks to tax limited partnerships with over 35 members as corporations.

Both the current and the 1977 Treasury plans propose repeal of the investment tax credit and the full taxation of capital gains, though the capital gains basis would be indexed for inflation. Both plans also recommend depreciation guidelines less generous than the current ACRS, though indexed to inflation. While the purpose of this indexation is good, it certainly would introduce a new element of complexity into the Tax Code not quite in keeping with the goal of simplification. Though under the 1977 Blueprints there would be no separate corporate income tax, the current plan establishes a 33 percent flat rate, down from 46 percent under current law.

The full taxation of capital gains is one of the more controversial elements of this tax reform. Under a comprehensive tax income concept, additions to net wealth ideally should be taxed as accrued, but at the very least should be taxed when realized. This follows the accretion income tax principle central to the whole concept of comprehensive income taxation. On the other hand, a strong argument can be made that this tax treatment of capital gains is inappropriate. Since the present value of the asset represents the discounted present value of the future income stream to be generated, an increase in the value of this income stream will be capitalized as a capital gain. Since this increased income will be subject to income taxation when received, a capital gains tax taxes the same income stream twice. This would raise the taxation of saving and investment, and also increase the threshold rate of return necessary to attract investment to risky endeavors. According to this point of view, capital gains taxation of income-producing assets is punitive and counterproductive.

Repeal of the investment tax credit would also be potentially costly, unless compensated. Although many so-called smokestack industries rely heavily on the Investment Tax Credit, so do other industries such as agriculture. Its use by heavy industry can be justified by pointing out that it compensates for the maintenance of the politically popular, but economically inefficient, corporate income tax. Industries such as agriculture, with relatively limited tax breaks from other sections of the code, benefit from the incentive given to capital formation, productivity, and efficiency.

The 1984 Treasury proposal might well be capable of closing tax loopholes across the income spectrum, and force some wealthy investors to enter the ranks of the taxpayers. However, administrative and legal changes in tax laws have not been completely successful in closing down tax shelter activity in the past. Although these may have some significant, if often temporary, effects, ingenious cultivators of the Tax Code can always find some way to shelter their income. One simple way to avoid generating taxable income is investment in general purpose municipal securities. Undoubtedly, the remaining deductions, credits, exemptions, and other preference items can always be combined in unforeseen ways to create tax shelters despite rigorous attempts to prevent them. As long as marginal tax rates are fairly high, the motivation will be there. Even a 35 percent maximum Federal marginal income tax rate is probably still too high to significantly reduce the attractiveness of tax shelters, especially considering the combined marginal tax rate imposed by all levels of government in many high tax States. Nonetheless, the sharp reduction in marginal tax rates certainly is the essential factor in lessening incentives to shelter income.

In terms of efficiency, the proposed reform would lessen the degree to which tax considerations influence investment in particular industries. The reduction in individual and corporate marginal tax rates, along with the elimination of many tax loopholes, would make the Tax Code more neutral and less distortive of intersectoral resource allocation. Although the proposed depreciation changes could well equalize the effective tax rates paid by various industries, to the extent the longer depreciation periods move the system away from the ideal of expensing, the gains from interindustry efficiency could be lost by a switch to longer write-off periods.

The reform would probably lead to a significant improvement in horizontal equity. The elimination or limitation of tax preferences clearly would severely restrict one's ability to manipulate the Tax Code. All in all, similarly situated taxpayers would end up paying a more roughly equal share of their income in taxes.

Although hailed as tax simplification, this proposal introduces some fairly complex provisions regarding depreciation and inflation adjustment. Also, to the extent existing loopholes are limited instead of eliminated, more complexity is created. On the other hand, the individual tax rate schedule is drastically streamlined, though it will be recalled that this schedule is not the source of most complexity in the Tax Code. On balance, individual taxation might be somewhat simplified, but corporate taxation could be more complex than under the current Tax Code. Notwithstanding the fact that sweeping simplification, now in vogue, would not be achieved, this criterion is not the most important one of tax policy.

Broad-Based Enhanced Savings Tax Act

On February 6, 1985, Senator Roth and Representative Moore reintroduced the Broad Based Enhanced Savings Act, or BEST. This legislation would sweep away most of the tax preferences except for the home mortgage interest deduction, charitable contribution deduction, a catastrophic medical expense deduction, business expenses for a personal business, and it would add a special tax deduction for saving. The individual marginal tax rate schedule would be compressed into four rates initially set at 18, 26, 36, and 45 percent, to be later adjusted so that in 1990 they end up at 12, 20, 30, and 34 percent. For couples filing jointly, the brackets would start at $3,550, $20,000, $30,000, and $60,000 of taxable income. Indexing would be retained. The package is designed to be revenue and distribution neutral.

In many respects, this plan resembles the Blueprints' model consumption tax. The tax base is broadened along the same lines, though BEST doesn't go quite as far, and much saving would not be taxed twice. BEST would designate super savings accounts (SUSA's) as the qualified accounts through which deductible saving may be channeled. After a phase-in period, the amount of such deductions would be limited to $10,000 for an individual and $20,000 for a married couple.

Like the other tax reforms, BEST would abolish most individual tax preferences to broaden the tax base. The two-earner deduction, State and local tax deductions, personal interest deductions, employer provided medical and life insurance premiums nontaxable to the employee, and the capital gains exclusion are among the provisions to be repealed.

A separate corporate income tax would remain in place, and corporate tax rates would not be affected. The investment tax credit would be repealed, but immediate expensing of machinery and equipment would be permitted for tax purposes by individuals subject to certain minor restrictions for some property. A five-year phase-in of expensing would be scheduled so that this provision would become fully effective in 1990. Structures which currently have recovery periods of 18 years would be depreciable in 15 years.

This proposal is a dramatic step toward a complete consumption tax system. It would virtually end the double taxation of saving and investment and so improve the prospects for capital formation and economic growth. BEST is relatively economically efficient and equitable. The base broadening would improve horizontal equity, and it has been designed not to redistribute the tax burden from one group of taxpayers to another. The base broadening and expensing elements are just two features that would greatly simplify the tax code.

Fair and Simple Tax

Representative Kemp and Senator Kasten reintroduced their Fair and Simple Tax (FAST) reform proposal on January 30 and January 31, 1985, respectively. Their current plan sets a flat 24 percent personal tax rate for taxable income for individuals, and broadens the tax base through elimination of numerous tax preferences. These repealed items include the two-earner deduction, the dividend exclusion, State and local tax deduction (except for real property), income averaging, dividend exclusion, child care credit, consumer interest deduction (except for loans used for residential property or education), and the residential energy credit. The capital gains exclusion has been modified. The taxpayer would be allowed to choose either full taxation of capital gains with a basis adjustment for inflation, or a 40 percent exclusion of unadjusted gains with the effective top tax rate capped at 17 percent. The personal exemption would be raised to $2,000, and the standard deduction increased to $2,600 for an individual, and set at $3,300 for a married couple. In addition, a new partial exclusion of employment income, not to exceed 20 percent, is established to offset social security taxes. This exclusion includes a phase-out formula for those earning more than $41,700 (in 1986) annually. The personal exemption, standard deduction, and employment income exclusion together ensure that a family of four would have no Federal income tax liability unless their adjusted gross income amounted to more than $14,375.

FAST sets a graduated rate schedule for corporations: a 15 percent rate on the first $50,000 of corporate income, and 25 percent on income between $50,000 and $100,000, and a 35 percent rate on income above this level. Corporate capital gains would be subject either to full taxation on gains indexed for inflation, or a 20 percent rate on non-indexed gains. But many corporate tax breaks would be eliminated or modified. FAST would repeal the investment tax credit, R&D tax credit, special tax treatment of employee stock ownership plans, and preferential treatment of certain natural resource exploration and extraction. The Accelerated Cost Recovery System would be modified to provide tax incentives equivalent to those under immediate expensing.

In the area of personal taxation, FAST establishes a tax base along the lines of a comprehensive income tax. Instead of the graduated three step marginal tax rate schedule proposed in the Blueprints, FAST would set a flat 24 percent tax rate. In the area of business taxation, FAST is a hybrid; in the same way as the current code, it retains a separate corporate income tax, but provides for tax treatment for investment which approaches that of consumption taxation. By reducing the corporate tax rate, however, FAST would lessen the disparity in effective tax rates borne by various industries.

By cutting the top personal marginal tax rate roughly in half, and the top corporate rate by around one-third, FAST would improve economic efficiency. Through increasing the incentive for saving, investment, and work, FAST would ensure that more of our productive resources were available for economic growth. Current Federal marginal tax rates, especially when combined with State income tax rates, still remain high enough to impede productive activity and distort resource allocation. Overall tax neutrality would be improved because the lower tax rates would not alter the relative prices of alternative activities and products to the same extent.

In personal taxation, FAST would clearly improve horizontal equity. The preferences that would remain enjoy wide support, such as the home mortgage interest deduction, charitable contributions deduction, IRA and Keogh deductions, and State and local general purpose obligation interest deduction. The plan has been designed to be revenue neutral and, according to static estimates, would not alter the relative shares of the tax burden paid by each income class. As has been mentioned, FAST would also increase horizontal equity in corporate taxation.

By completely eliminating many loopholes, and setting only one personal tax rate and three corporate rates, FAST would greatly simplify the tax system. Furthermore, the adoption of a single personal rate makes it somewhat harder to target tax rate increases on particular groups.

Moreover, the value of tax loopholes would fall dramatically with the lowering of the tax rates. With a 28.8 percent effective top marginal rate, further measures to legally restrict tax shelter activities almost become superfluous. The most important single step would already have been taken by cutting the tax rates.

A significant drawback to FAST, which is inherent in any plan taxing income, is the double taxation of much saving.

Symms-DeConcini Plan

This tax plan, sponsored by Senators Symms and DeConcini, and reintroduced in Congress on January 31, 1985, was one of the first flat rate proposals to gain wide recognition. It is essentially identical to the tax plan devised by Professors Hall and Rabushka of Stanford University. The reform would set a single 19 percent tax rate applied to individual and business taxable income. A principle of this plan is that all income should be taxed only once, as close to its source as possible. Furthermore, the plan would remove the poor from the tax rolls, and simplify the tax system enough that all tax returns could fit onto one page.

The tax base would be broadened by the elimination of virtually all preference items, and would consist of compensation from employers in the form of wages and salaries, market value of fringe benefits, and pension contributions. Interest, investment income, and capital gains on securities would not be taxable. Although superficially resembling a modified income tax, it is actually closer to a consumption tax. Though amounts saved are subject to tax, the return from such saving and investment is not. By eliminating the double taxation of saving, albeit in a different way than does the cash flow model, the tax treatment of saving under this flat tax is essentially equivalent to consumption tax treatment.

Individual taxation would be simpler than the current tax code. Individual tax returns could be filed on a form no bigger than a post card. The repeal of most tax preferences and the setting of a single 19 percent flat rate would so dramatically streamline the Tax Code that few taxpayers would need assistance to complete their returns. After the reform, potential manipulation of the Tax Code would be severely limited, thus ensuring that similarly situated taxpayers pay roughly the same amount of tax.

Corporate taxation, by necessity, would be a more complicated affair. Ordinary and necessary business expenses could still be deducted. This would include costs of goods and services and employee compensation. Furthermore, capital outlays could be expensed in the same year as the investment was made. However, interest, depreciation, or payment to owners, would not be deductible to the corporation.

This package would improve the economic efficiency of the tax system in many ways. First, marginal tax rates would be cut deeply, and the intertemporal distortion arising from the double taxation of saving would be eliminated. Consequently, the incentive to save and invest would rise, fostering increased capital formation and economic growth. Moreover, intersectoral distortion caused by the differential taxation of various forms of investment and industries would be all but ended. The uniform taxation of income, regardless of source, would also end the distortions arising from the different tax rates now applied to individual and corporate income. In sum, the Symms-DeConcini plan would substantially sweep away tax provisions which currently alter decisions from what they would be in the absence of taxation and, thereby, make a significant step toward that elusive goal of tax neutrality.

Horizontal equity, as suggested earlier, would also be greatly improved. Within each income class, the average tax rate would be almost the same, because there would be few ways to reduce tax liability. However, opponents have argued that much of the tax burden would be lifted from the rich to the middle class and poor, even if superior economic performance does increase the income of all sectors of the population. As stated, the plan would certainly drastically simplify the tax system, perhaps more than any other major tax reform bill.

The Bradley-Gephardt Tax Plan

This plan, reintroduced as the Fair Tax of 1985 (FAIR) on February 6, 1985, is one of the best known tax reform proposals. In many ways, the Bradley-Gephardt bill approaches the idea of comprehensive income taxation, though the usual preference items appear not to be greatly altered. Though its three-tiered rate structure is similar to that of many other reform proposals, a unique feature of the rate schedule is used to expand the tax base. In this way, popular deductions that could not be repealed openly would be severely curtailed.

FAIR would repeal personal tax preferences such as the two-earner deduction, residential energy credit, dividend exclusion, capital gains exclusion, and deduction for State and local taxes, aside from income and real property taxes. Further, the medical expense deduction only applies to such expenses over 10 percent of Adjusted Gross Income (AGI), and indexing of personal tax brackets is repealed. The personal exemption would be increased to $1,600 for the taxpayers and spouse, and the zero bracket amount would rise to $3,000 for individuals, and $6,000 for married couples filing jointly.

The bill would set a flat 14 percent "normal" tax rate and a two-step graduated surtax schedule of 12 percent and 16 percent. The normal tax rate would be applied to taxable income; that is, adjusted gross income after deduction. However, the 12 percent surtax rate would be applied to AGI between $25,000 and $37,500 of single taxpayers, and AGI between $40,000 and $65,000 of taxpayers filing jointly. The 16 percent rate would be applied to the AGI of single persons in excess of $37,500, and $65,000 for that of joint returns.

Thus, Bradley-Gephardt establishes two tax bases: taxable income taxed at the 14 percent normal rate, and adjusted gross income which is taxed at the applicable surtax rate. The effect is to greatly reduce the utility of those deductions that are judged too popular to repeal outright. Regardless of one's tax bracket, every dollar of deduction is worth, at most, 14 percent of lower tax liability. For taxpayers with income subject to the surtax, this is equivalent to capping deductions at a fraction of their current value. Presumably, Bradley-Gephardt opted for the former approach because it might prove less controversial.

FAIR would lower the corporate tax rate to 30 percent, and repeal many tax preferences. The Investment Tax Credit, Accelerated Cost Recovery System, and Research and Development tax credit would be eliminated, and the treatment of natural resource extraction made less generous. The corporate capital gains tax rate would be boosted from 28 to 30 percent.

In many ways, the Bradley-Gephardt bill resembles the recently released Treasury Tax Reform proposal. Both are variants of the comprehensive income tax model, and thus broaden the individual tax base by repealing the same tax provisions. However, the Treasury plan includes several items not contained in Bradley-Gephardt. First of all, the Treasury plan would retain the inflation indexing of individual tax brackets and the personal exemption. Without this feature, inflation would result in bracket-creep tax increases. Moreover, it is argued, repeal of indexing would give the Government another incentive to encourage an inflationary monetary policy, a temptation that would be hard to resist given current and most likely future budget problems. Second, the Treasury reform, though repealing the capital gains exclusion, would index the basis for inflation. This would lessen the tax burden on innovation and risk-taking relative to the Bradley-Gephardt plan. Third, the Treasury plan uses only one individual tax base, not two, as the Bradley-Gephardt plan does. The Bradley-Gephardt bill would actually multiply the complexity of the current Tax Code for many taxpayers.

In general, the Bradley-Gephardt bill would increase taxation of capital formation and hence tend to reduce economic growth. High technology and other fast growing firms would be hit with a 50 percent increase in the capital gains maximum tax rate and repeal of the R&D credit, while capital intensive industries would lose accelerated depreciation, the Investment Tax Credit, and other benefits which decrease the tax burden on business saving.

CONCLUSION

The political and economic case for tax reform is compelling. Public opinion rightly views the current Tax Code as unfair, and economists across the political spectrum know it is inefficient. The various reform plans discussed here illustrate how far tax policy has come in recent years. The current trend is toward lowering marginal tax rates instead of raising them. With lower marginal tax rates, tax loopholes lose much of their appeal, and the effect of repealing special tax measures becomes less important. After all, it has been the excessive tax rates which made many tax breaks economically necessary or desirable. In addition, many superfluous tax provisions inserted for social policy or political reasons would lose much of their appeal with a significantly lower tax rate structure. Under a tax reform plan which sharply lowered marginal tax rates, the cost of repealing many of the tax loopholes would be minor compared to the benefits of the whole package. This is the driving force of current tax reform efforts.

Chapter V. EMPLOYMENT

INTRODUCTION

During the past two years, the civilian unemployment rate has fallen at an unprecedented pace. The rapid and vigorous economic recovery has proven to be the most effective jobs program for America. Yet, as the level of unemployment diminishes, the primary nature of our Nation's unemployment problem is gradually shifting from one of cyclical unemployment—unemployment that can be effectively combated through aggregate or macroeconomic policies—to one of structural unemployment. New policy initiatives—initiatives aimed at improving the functioning of specific labor markets—must soon be instituted if we are to achieve an unemployment rate below the 7.1 percent forecast by the Congressional Budget Office (CBO) for 1985. This is one of the challenges facing the 99th Congress.

This chapter describes the tremendous labor market gains that have been achieved during the current economic expansion and outlines the concomitant shift in the causes and burden of unemployment in the United States. The chapter contrasts the performance of our Nation's relatively unfettered labor markets over the past two decades with the disappointing performance of the more rigid and highly regulated European labor markets. Finally, taking into account both the proven strengths of the U.S. economic system and the nature of the remaining unemployment problem in the United States, there is discussion of the policies that Congress could consider in its efforts to combat structural unemployment.

THE DECLINE IN CYCLICAL UNEMPLOYMENT IN 1983 AND 1984

Between November of 1982 and January of 1985, the ongoing economic expansion lowered the unemployment rate in the United States from 10.7 percent to 7.4 percent of the civilian labor force. There are 3.4 million fewer Americans unemployed today than there were at the recession trough in November 1982. This is an unprecedented performance; it marks the greatest decline in unemployment seen in any 26-month period during the postwar period. In addition, most economists believe that sustained economic growth in 1985 and beyond will lead to still further declines in unemployment. If so, that should break a long uptrend of higher and higher unemployment rate troughs. Each recession in the past 25 years has begun at a higher rate of unemployment than the previous one. That undesirable trend line should be broken in this recovery.

In 1984, the decline in the number of unemployed Americans was accompanied by a fall in the number of discouraged workers—Americans who reported that they were not seeking employment due to a belief that it could not be found—and by a decline in the typical duration of unemployment. For example, in November 1983, 35 percent of the unemployed had been searching for less than five weeks; by November 1984, 41 percent of the unemployed fell into this category. Fewer Americans now suffer from the economic hardships and the mental and physical distress that long-term unemployment and associated labor market problems bring.

In particular, the decline in long-term unemployment may now be reducing the proportion of the U.S. population living in poverty. Although the official Census Bureau figures are not yet available, projections prepared for the Joint Economic Committee (JEC) by the Congressional Research Service (CRS) indicate that between 1983 and 1984 the poverty rate in the United States fell by as much as a full percentage point. If the CRS figure is accurate, the current recovery is being accompanied by the first significant drop in the U.S. poverty rate since 1976. In most cases, of course, unemployment is not associated with poverty. The presence of other wage earners in the household, social insurance programs, and the typically short duration of unemployment in the United States all help to protect the unemployed from actual poverty. In 1983, almost half of all workers experiencing unemployment were members of families with incomes of more than $20,000. It is evident that the current decline in cyclical unemployment—in addition to its direct impact on the number of Americans in poverty—has saved thousands more of American workers from the emotional distress, the sudden loss of income, the curtailed consumption, and the accumulating debt that unemployment brings even to those with incomes above the poverty threshold.

THE LIMITS OF MACROECONOMIC POLICIES

Due in part to a firm monetary policy, this dramatic cyclical decline in unemployment and in its associated hardships has been accompanied by a fall in the expected rate of inflation, rather than by rising inflationary expectations and escalating nominal wage increases. This may well indicate that there has been a realignment in the relationship between inflation and unemployment. The current civilian unemployment rate of 7.3 percent—which was consistent with an inflation rate of more than 12 percent in 1980—is now occurring with an inflation rate of approximately 4 percent.

Nonetheless, repeated econometric studies indicate that—without an accelerating rate of inflation—macroeconomic policies cannot lower the unemployment rate below a specified threshold. Many economists believe that the unemployment rate corresponding to this inflation threshold is now somewhere in the range between 6.0 and 7.0 percent. At this point, the remaining unemployment is thought to be associated primarily with the structure of the U.S. labor force and its labor market institutions, and not with cyclical economic conditions.

In part, this underlying unemployment rate of 6.0 to 7.0 percent reflects the fact that labor markets in our dynamic economy are in a continual state of flux. At any moment, some individuals are quitting jobs to look for better opportunities and others are choosing to enter or reenter the labor force. In addition, shifts in consumer demands and the introduction of new products and new technologies mean that—while the aggregate number of job vacancies in the economy may match the aggregate number of job seekers—the geographic location of the jobs and skills required to fill them do not match the locations and skills of the unemployed.

Yet, while there will always be some level of structural unemployment, there is agreement that the current level of structural unemployment in the United States is too great. Labor market imperfections—including discrimination, lack of information about employment opportunities, and insufficient wage flexibility—offer a more plausible explanation for the persistence of long-term unemployment in depressed areas and among disadvantaged population groups. As we win the battle against cyclical unemployment, this remaining problem of structural unemployment becomes increasingly evident.

In the short run, a sharp boost in aggregate demand could drive unemployment below the cyclical lower threshold of 6.0 to 7.0 percent. This would, at least temporarily, lower unemployment rates for all population groups, including those suffering from structural unemployment. Over the long run, however, this would prove self-defeating; the expected level of inflation would itself rise, leading to an ever-accelerating wage-price spiral. Inflation is not an appropriate—or, ultimately, even an effective tool—to use in fighting unemployment in the United States. Instead, Congress must consider policy initiatives that are designed to lower the cyclical lower limit for unemployment itself. Some examples of such initiatives—initiatives directed at lowering the unemployment threshold by improving the efficiency and performance of specific labor markets—will be outlined at the end of this chapter.

TRENDS IN NONCYCLICAL UNEMPLOYMENT

There is persuasive evidence that the underlying level of structural unemployment in the United States rose gradually during the 1960's and 1970's, perhaps by as much as two full percentage points. What are the factors behind this rise? Is it an indication that our labor markets are not operating as efficiently as in the past? What are the prospects for the 1980's?

The single most important factor behind the rise in structural unemployment was undoubtedly the baby boom that poured thousands of youthful new entrants into the U.S. labor market in the 1970's. Table V.1 shows how the proportion of the civilian labor force aged 16 to 24 increased during this period.

TABLE V.1.—PROPORTION OF PERSONS AGED 16–24 IN THE U.S. LABOR FORCE

	Percent
Year:	
1960	16.6
1965	19.0
1970	21.6
1975	24.2
1980	23.7
1983	21.7

Source: Bureau of Labor Statistics.

Since young persons traditionally have higher turnover and unemployment rates than do other groups in the population, this shift in the composition of the labor force was one factor that pushed up the aggregate unemployment rate. Taking into account the different unemployment rates of a wide variety of age and sex groups in the population, it has been estimated that shifts in the age-sex structure of the U.S. labor force could account for as much as one-half of the increase in structural unemployment observed in the 1960's and 1970's.

To the extent that it can be attributed directly to shifts in the composition of the labor force, the increase in structural unemployment in the United States is not a signal that our labor markets are becoming more inefficient. Futhermore, as Table V.1 indicates, the baby boom has now been absorbed into the labor force. In the 1980's and 1990's, the effect of demographic factors may be to shift the aggregate level of structural unemployment downward.

It may also be found that—just as rapid shifts in the composition of the work force have placed new strains on our labor markets—so too have rapid changes in the structure of the economy itself. In 1960, 46 percent of all private nonagricultural jobs were in trade, business and health services, finance insurance, and real estate. But between 1960 and 1984, over 80 percent of all new private nonagricultural jobs were in these industries. The rapid pace of this change may be reflected in the increased disparity seen between the unemployment rates of different industries and locations in the United States and in the higher aggregate level of structural unemployment. While this could certainly be a serious problem in the long run, the United States will not enjoy the benefits of rapid economic growth if an attempt is made to resist structural change in the economy. The task must be to make U.S. labor markets more flexible and better able to cope with change itself.

Finally, some of the rise in structural unemployment during the 1960's and 1970's can be traced to legislated changes in labor markets. Expansion of the coverage of the Federal minimum wage and expansion of the unemployment insurance system are two of the most frequently cited examples of such changes. Many economists believe that the minimum wage contributes heavily to unemployment among the least skilled workers, including inexperienced black youth. Unemployment insurance affects unemployment rates not only by encouraging persons to prolong their spells of unemployment but—perhaps even more importantly—by making it less costly for firms to lay off workers. Although it is difficult to quantify the precise effects of these programs, a wide variety of empirical studies indicate that their expansion has had a significant effect on the level of structural unemployment.

In summary, the underlying level of structural unemployment in the United States rose during the 1960's and 1970's. Among the factors contributing to this rise were the direct effects of rapid labor force growth among population groups with traditionally high unemployment rates, the added stresses imposed on labor markets by rapid shifts in the composition of the labor force and in the structure of the economy, and legislated changes in labor markets. Since the proportion of youth in the labor force is projected to decline throughout the 1980's and 1990's, the first factor may now be working to lower the level of structural unemployment. Nonetheless, whether the United States will actually experience a decline in structural unemployment in the 1980's may depend on the extent to which Congress adopts policies to make labor markets more flexible and better able to cope with rapid economic change.

Policies To Protect the Existing Strengths of Our Labor Markets and To Promote Lower Structural Unemployment

In the search for policies to improve the functioning of U.S. labor markets, it is essential to not lose sight of the fundamental success of our economic system with its relatively unfettered labor markets. Since 1970, the U.S. economy has generated over 20 million jobs, increasing civilian employment by more than one-third. By contrast, in the four largest European nations (Britain, Germany, France, and Italy) over one million jobs have been lost since 1970.

As shown in Table V.2, the average level of unemployment in these European nations has risen relative to the level in the United States, even though these nations have not been subjected to the stresses that rapid labor force growth has imposed on the U.S. economy. The Organization for Economic Cooperation and Development forecasts further increases in European unemployment through 1985. The OECD maintains that future job prospects in Europe depend as much on the specific policies governments adopt to meet the unemployment challenge as on the strength of the economic recovery.

TABLE V.2.—CIVILIAN UNEMPLOYMENT RATES IN THE UNITED STATES AS COMPARED TO THE AVERAGE FOR THE FOUR LARGEST EUROPEAN NATIONS

Period	Average rate for United States	Average rate for Britain, Germany, France, and Italy
1970 to 1974	5.4	2.4
1975 to 1979	7.0	4.4
1980 to 1983	8.5	7.1

Source: Calculated from the Bureau of Labor Statistics, "Statistical Supplement to International Comparisons of Unemployment," Bulletin 1979. European average is weighted by size of the labor force.

Among the factors most frequently cited to explain the relative success of American labor markets in accommodating rapid social and economic change without a greater rise in structural unemployment are: the greater geographic and occupational mobility of American workers; greater flexibility in real wages; the relative freedom that employers in declining industries have in laying off unneeded workers, and the lower level of government and union regulation of labor markets and industry in general. One of the most effective ways to combat structural unemployment in the United States is to enhance and protect these existing strengths in our labor markets. Below are cited some examples of the kinds of policies that Congress might wish to consider in its efforts to do this.

The Federal Minimum Wage and the Youth Labor Market

During the past two years, the unemployment rate among young adults has fallen sharply in response to strong economic growth. Nonetheless, unemployment among youth, especially minority youth, is still at an unacceptable level.

The problem of youth unemployment is a long-standing one. Over the course of the past 30 years, there has been a well documented rise in the level of youth unemployment. For all youth aged 16 to 19, the unemployment rate grew from 12.6 percent in 1954 to 17.8 percent in 1980, approximately the same level it stands at today. Over these same three decades, the gap between the unemployment rates of white and nonwhite youths grew from virtually zero to more than 25 percentage points. Since 1973, the unemployment rate for black youth has remained above 30 percent even at business cycle peaks. As dramatic as they are, these employment figures understate the true severity of the problem because they do not take into account youths who, discouraged by previous failures to find a job, have ceased to actively search for employment.

A wide variety of social and economic factors are believed to account for the persistent labor market problems experienced by some youth. In recent years, one of these factors may have been the expanded coverage of youth-intensive service sector jobs by the Federal minimum wage. The 1966 amendments to the Fair Labor Standards Act added hospitals, schools, laundries, hotels, motels, and restaurants to the list of covered industries. Most economists agree that the current minimum wage of $3.35 per hour restricts employment opportunities for youth with little labor market experience. Youth aged 16 to 19—who account for approximately 6 percent of all workers in America—account for over 30 percent of all minimum wage workers. To the extent that youth who could have found jobs at a lower wage remain in the labor market—and to the extent that the minimum wage attracts new entrants—the unemployment rate for youth is also raised.

In the past, efforts to deal with youth unemployment through programs linking education and training to employment opportunities have achieved widespread, bipartisan support. Many of the provisions of the Job Training Partnership Act enacted in 1982 are specifically designed to help disadvantaged youth obtain the qualifications required for jobs in the private sector. To be successful, the training must raise the productivity of the youth at least to the point where the employer can afford to pay the minimum wage plus payroll taxes.

It is clear, however, that much more needs to be done. Specifically, it may be time for Congress to consider relaxing the restrictions imposed by the minimum wage on youth employment through the adoption of a differential minimum wage for youth. The differential might be for summer employment only, as in the case of the Youth Employment Opportunity Wage proposed by the Administration and endorsed by the National Conference of Black Mayors in 1984. Alternatively, it might take the form of a permanent, year-round differential. It is not to be supposed that any single piece of legislation will eliminate the problem of youth unemployment. Yet, if a differential minimum wage allowed a decline in youth unemployment of even 2 or 3 percentage points—an estimate that many economists consider reasonable—it would have had a greater impact than the billions that have been spent in the past on public jobs programs.

Federal Restrictions on Work in the Home

Under the terms of the Fair Labor Standards Act (FLSA) of 1938, the Secretary of Labor is empowered to restrict or prohibit industrial homework where necessary to prevent evasion of the Federal minimum wage law. Since the early 1940's, manufacturers in seven industries have been banned from employing persons to do work at home. Recently, however, the ban against homework in the knitted outerwear industry was lifted on the grounds that adequate enforcement of the minimum wage provisions of the FLSA among these homeworkers was in fact possible. Overall, the Labor Department now has had 45 years of experience in conducting minimum wage investigations in a wide variety of industries and occupations where time clocks are not maintained and employees not closely supervised. It becomes increasingly questionable whether adequate enforcement of the minimum wage standard requires a blanket prohibition on homework in any industry.

The original intent of the homework restrictions was to protect women and children from working for low wages in crowded tenements. Today, however, the primary effect of the homework restrictions may not be to raise wages but to limit employment opportunities for those in rural areas where other jobs may be scarce, for women with small children, for the elderly, and for those who simply prefer to work at home. Those individuals actually engaged in homework and their advocates—including the American Farm Bureau and the National Alliance of Homebased Businesswomen—are the strongest supporters of efforts to lift these restrictions.

Recognizing this, a "Freedom of the Workplace Act" was introduced during the 98th Congress. Sponsored by Senator Orrin Hatch, this bill would have amended the FLSA to permit individuals in every industry to engage in homework so long as their employment did not actually violate the minimum wage and overtime provisions of the FLSA. The 99th Congress may wish to consider this or a similar amendment that will protect homeworkers without denying them the opportunity to work at home.

The number of workers affected by the remaining ban on homework in six industries is relatively small. Nonetheless, it is estimated that approximately five million Americans in nonrestricted industries currently earn their living at home. This number could grow rapidly as new computer and communication technologies increase the opportunities for professional and clerical homeworkers. Eventually, the growth of such opportunities could help to reduce structural unemployment among single mothers and others who find it difficult or expensive to work outside of the home. Legislation safeguarding the right of Americans to work at home—subject to the wage and hour provisions of the FLSA—could facilitate this growth.

Enterprise Zones and Structural Unemployment

In the past two years, the concept of enterprise zones—specifically designated zones in economically depressed areas that would benefit from reduced taxation and less government regulation—has received widespread attention at both the Federal and State levels. Such zones would attack structural unemployment by stimulating private, job-creating investment. Unfortunately, despite widespread, bipartisan support for the concept, efforts to pass Federal legislation that would allow the establishment of a limited number of experimental zones have been repeatedly blocked by the House Ways and Means Committee.

Legislative efforts at the State level have been more successful. Twenty-four States have now passed laws to establish special tax incentives for investment in depressed neighborhoods, and over 400 zones in 18 States are already functioning. A survey of State enterprise zone administrators indicates that nearly 60,000 jobs have already been created or saved by the State incentives, and that more than 160 new firms have started up in the State-designated enterprise zones. The evidence available to date suggests that virtually all of the new enterprise zone employment is coming from either these business startups or from the expansion of existing zone-based businesses, rather than from the relocation of firms. Furthermore, in the five zones where the hiring practices of firms have been examined, about 30 percent of the jobs created have gone to unemployed workers and residents, including the long-term unemployed.

The State plans vary widely in terms of the incentives they offer, and it is difficult to assess the impact that combinations of State and Federal enterprise zone incentives would have. Nonetheless, the premise underlying the enterprise zone concept—that private enterprise and individual initiative can do more for depressed areas than direct government expenditures—is sound. Passage of a Federal enterprise zone act—even if on a limited, experimental basis—would enable us to learn more about costs and effectiveness of this innovative approach to generating employment opportunities for the disadvantaged.

Unemployment Insurance and Structural Unemployment

The current Federal-State unemployment insurance system performs a vital function in helping to protect American workers from the financial hardships imposed by unemployment. While there is substantial empirical evidence that the availability of benefits raises structural unemployment by encouraging individuals to lengthen their job search, any social insurance system designed to make unemployment less onerous would have a similar effect.

There is, however, another aspect of the unemployment insurance system that also works to raise the level of structural unemployment. This is the subsidy that the system, as it is currently financed, offers to firms that rely heavily on layoffs to manage their work force. In determining unemployment insurance tax rates, all States now have at least some provision for the experience rating of employers. The purpose of experience rating is to ensure that firms that impose high costs on the insurance system through frequent layoffs bear the burden of those costs in the form of higher unemployment insurance tax rates. Unfortunately, the existence of minimum and maximum tax rates in most States effectively screens a large proportion of firms from experience rating. A firm that pays the State's maximum tax rate is free to increase layoffs without incurring additional unemployment insurance taxes. In the long run, the firm's laid-off employees are likely to collect more in benefits from the system than the firm contributes in taxes. The difference is made up in part by firms that rarely, if ever, lay off employees but are nonetheless forced to pay a minimum tax rate.

Overall, the effect of imperfect experience rating is to subsidize wages and employment in industries that are highly seasonal or cyclical at the cost of jobs in industries and firms that offer more stable employment opportunities. The implicit subsidy can amount to as much as 9 percent of gross wages. There is mounting evidence that these subsidies increase the layoff rate in the U.S. economy and make a substantial contribution to structural unemployment. The President's Commission on Industrial Competitiveness has recommended that States restructure their experience rating of the unemployment insurance system to alleviate this problem. Congress might wish to facilitate this by making more effective experience rating a requirement for States participating in the unemployment insurance program.

CONCLUSION

The past two years have witnessed a dramatic decline in cyclical unemployment and its accompanying hardships. Further strides are anticipated in 1985. With the Congressional Budget Office forecasting an average civilian unemployment rate of 7.1 percent for 1985, and our predicting that we will come in lower than that, it appears that we are nearing victory in the battle to combine low cyclical unemployment with low inflation.

It is also clear that our labor markets have performed exceptionally well over the longer run. Since 1970, over 20 million new jobs have been created as the U.S. economy has accommodated not only rapid labor force growth but also a rapid shift in the demographic composition of the labor force. A major factor contributing to this achievement has been our system of relatively unfettered and competitive labor markets. Recognizing this, we urge that Congress—in its efforts to combat the persistent labor market problems encountered by minority youth, women, nonwhite males, and residents of economically depressed areas—focus new attention on policies designed to improve the access of these groups to labor markets and to further enhance the flexibility of those labor markets.

Chapter VI. REFORM OF THE FEDERAL RESERVE SYSTEM

The Federal Reserve System has one of the most powerful, if not the most powerful, mandates in the world—control of the U.S. money supply. Most economists would agree that actual acceleration in the growth or decline in the U.S. monetary aggregates increases or decreases economic activity. Most economists would also agree that rapid growth in money will eventually lead to higher inflation. Thus, the Federal Reserve System (Fed) has at least some control over U.S. and international economic growth, unemployment, and inflation.

With this sort of economic power, it is no wonder that the 99th Congress should take a very careful look at "appropriate" Fed policy. But what is appropriate policy? To help grapple with that question, this chapter presents a historical perspective of our current Federal Reserve System and focuses on the current goals for the Fed, as mandated by the Congress. Recent volatility of the money supply and the announcement policy of Federal Open Market Committee (FOMC) decisions are also discussed.

THE FEDERAL RESERVE SYSTEM: A HISTORICAL PERSPECTIVE

The First and Second Banks of the United States (1791-1811 and 1816-1836, respectively) represented the only two examples of formal, central type banks in America until the Federal Reserve System was established in 1913. It was generally felt that, to a new nation still savoring the overthrow of centralized British financial management, central banking simply proved to be intolerable. On balance, the First and Second Banks of the United States performed adequately; however, the charters for both banks were not renewed due to political pressures and perceptions of monopolistic behavior by both business and Congress.

In the interim period between the Second Bank of the United States and the creation of the Federal Reserve System in 1913, many central bank duties were delegated to the Treasury Department, while monetary policy was governed by the National Bank Act and the crosscurrents of the international gold standard.

The Fed was initiated and later grew in importance in response to financial "crises." The "Rich Man's Panic" of 1907—where many New York banks closed their doors—prompted Congress to pass the Federal Reserve Act in December 1913. This Act produced a geographically distributed central banking system with Federal Reserve banks located in 12 cities. The Fed's policymaking body, the Board of Governors, consisted of the Secretary of the Treasury, the Comptroller of the Currency, and five presidential appointees.

The initial focus of the Federal Reserve Act was to lend reserves to the banking industry rather than to implement and execute a monetary policy. At that time, controlling the discount rate and conducting open market operations were the responsibility of the separate district banks, not the Board of Governors.

The period following the passage of the Federal Reserve Act and through the 1920's and 1930's was marked by the Federal Reserve Board gradually gaining ascendancy over the Federal Reserve district banks. This period saw a strengthening of the Board which served to benefit attempts at a centralized policy, but concomitantly decreased the autonomy of the district banks.

Primarily due to the banking collapse of 1930 to 1933, the Fed grew in importance. Backed by Franklin Roosevelt and Congress, the Federal Reserve System expanded its domain and gained independence as a result of the Banking Acts of 1933 and 1935. Some specific provisions of those Acts are outlined below:

- Legislated the removal of the Secretary of the Treasury, as well as the Comptroller of the Currency from the Federal Reserve Board. Restructured the Board of Governors to its present form—seven presidential appointees, confirmed by the Senate, serving 14-year terms. This allowed the Board, especially the Chairman, to have a stronger impact in the formulation of policy.
- Removed even more autonomy from the district banks and concentrated more power in the Board of Governors. For example, reserve ratios and discounting were set by the Board. The original regional distribution of district banks was intended to give equal representation to the Nation's various economic interests. The centralization of authority that was effected by the Banking Acts of 1933 and 1935 served to negate much of the original attempts at regional equity made by the Federal Reserve Act of 1913.
- The Federal Open Market Committee (FOMC) was formally created. The FOMC determined policy through the purchase and sale of government securities, influencing directly the money supply and interest rates. The brisk gains in power by the Board of Governors and Federal Open Market Committee were due, in large part, to Congress' distress over the ascendancy of the executive branch. Earlier legislation had granted large blocks of authority to the Secretary of the Treasury and the President. Congress, in the Banking Act of 1935, tried to recoup some of its losses.

During World War II, and immediately thereafter, the Federal Reserve was subordinated to the Treasury. During this period, the Federal Reserve pegged the prices of government securities and abandoned its power over the money supply. The Treasury-Federal Reserve "Accord of 1951" curbed the practice of pegging securities prices and raised the credibility of the Fed relative to the Treasury Department and the Administration.

As the United States and other industrialized nations left the gold standard in the 1930's, management of the money supply gained a new prominence. With its increase in influence, the Fed acquired a corresponding number of critics. In 1964, discussion of the ascendancy of the Federal Reserve reached a frenzy at a series of hearings entitled "The Federal Reserve System After Fifty Years," sponsored by the House Committee on Banking and Currency. During these hearings, Chairman Wright Patman, condemned the Federal Reserve for what he saw as its excessive aloofness and unbridled freedom. This series of hearings was accompanied by the introduction of several bills designed to limit the power of the Fed. Although none of these bills were passed, they set the stage for later events.

Probably the most salient effort in addressing the independence of the Federal Reserve in recent history is embodied in the 1978 amendments to the Employment Act of 1946. The Full Employment and Balanced Growth Act of 1978 (Humphrey-Hawkins) was the legislative branch's attempt to strengthen the commitment of the Federal Government to a high employment, low inflation economy. Humphrey-Hawkins, for the first time, statutorially outlined a procedure by which basic economic goals are to be established by the President, Congress, and the Federal Reserve. In the Annual Economic Report, the President is required to establish numerical goals for employment, unemployment, production, real income, productivity, and prices during the succeeding five years. When enacted, Humphrey-Hawkins specified goals of 3 percent adult and 4 percent overall unemployment rate by 1983 as well as 3 percent inflation goal by 1983, and zero percent by 1988.

Humphrey-Hawkins specifically requires that the Federal Reserve Board report to Congress twice a year. This report must detail its intended policy for the ensuing year and the relationship of that policy to the President's goals set forth in the Economic Report of the President.

The Fed is also required to announce monetary targets for the upcoming calendar year. Changes to these targets can only be made under extraordinary circumstances.

Basically, the intent of the Humphrey-Hawkins Act is "to bring us back to full employment, full production, and full real income on a balanced and sustainable basis."

The unemployment rate set by the Humphrey-Hawkins legislation assumes a "natural" rate of unemployment of 4 percent. However, since the natural rate of unemployment is much higher than that, any attempt at lowering the rate below its full employment level would generally be expected to result in high inflation. High inflation, however, is inconsistent with Humphrey-Hawkins goals—thus the contradiction.

Most economists would agree that the Fed—at least in the short run—could lower unemployment to the 4 percent level by unexpectedly increasing the growth rate of money. This increase in the growth rate of money will fuel inflation and reverse any downward trend in interest rates. As interest rates climb, economic activity would falter and unemployment would start to rise. Further pressure would be put on the Fed by Congress to increase the growth rate of money leading to: higher inflation, higher interests rates, and pressure for a more rapid growth rate in money. Eventually, this vicious cycle will result in instability in both the financial and political system. This instability can be avoided by having Congress set reasonable goals for the Federal Reserve.

REFORMING THE FEDERAL RESERVE

Humphrey-Hawkins improved the Fed's accountability by establishing goals for the Fed in the areas of unemployment and inflation by mandating Fed calendar year monetary targets. The Fed has generally tried to follow a course that provides monetary stimulus during a recesssion and monetary constraint during an expansion. In this way, the Fed has tried to even out economic ups and downs.

In practice, this noble course was often in error. Given the recognition lags and impact-of-policy-change lags, timing of policy changes was often poor. For example, by the time the Fed would realize the economy was entering an economic downturn, and would therefore apply monetary stimulus, which would have an impact beginning several months afterwards, the economy was already starting to recover and the added stimulus would "overheat" or overstimulate the recovery. Thus, many times the Fed's policies were pro-cyclical and worsened an already bad situation.

Congress hoped that by forcing the Fed to pre-announce its monetary growth targets for the upcoming calendar year, pro-cyclical behavior would be curbed. This is to say that by curbing the Fed's discretionary control over the money supply—by holding it accountable for any deviations from the pre-announced targets—the Fed's historically pro-cyclical behavior would be reduced.

The Fed's effort to meet these monetary targets has been a difficult task to achieve. In the last six years, the Fed has hit its annual target ranges only twice.

Furthermore, over the last few years, volatility in the money supply has increased dramatically. This volatility has significantly increased the uncertainty in financial markets causing volatility in security prices and generally raising interest rates.

Finally, the Fed has an internal policy that the deliberations of the FOMC (i.e., the meeting of the policy board that dictates monetary policy) may not be released publicly until after the next FOMC meeting—generally longer than one month. This means that extremely important economic information is withheld from the financial markets for over one month. Because the Fed is secretive about its policy decisions, the financial markets are moved by rumor and innuendo. This results in a general increase in market volatility and risk.

The Fed policy problems discussed above can be addressed by appropriate congressional action. Instead of mandating a particular unemployment rate that may or may not be the natural rate, Congress could require the Fed to follow a steady, noninflationary growth path in money. This policy prescription would allow for a sustainably low inflation rate and an unemployment rate that would approximate the natural rate over time.

As recommended by the President's Council of Economic Advisers in the Economic Report of the President, February 1985, the Federal Reserve's method of announcing its monetary growth targets is ambiguous and subject to revision, adding to the uncertainty in the financial markets. The method recommended is to set the base for each year's monetary growth target range at the midpoint of the prior year's range rather than the average actual money stock in the previous fourth calendar quarter. This methodological improvement would avoid "base drift" from one year to the next. But, also, it should contribute to noninflationary expectations by the financial markets, because deviations from the middle of the range would lead to predictable measures on the part of the monetary authority to restore stability.

Finally, the Fed should announce its FOMC decisions immediately after they are made. This would enable all financial market participants to base their investment decisions on fact instead of rumors and innuendo. Uncertainty would also decline, and efficiency rise, as the financial markets become better informed.

Chapter VII. THE INTERNATIONAL TRADING SYSTEM

For the past 50 years, U.S. trade policy has been guided by free trade theory grounded in the real world by the establishment of trade agreements with other countries. The basic theoretical assumption has been that international trade is a "positive sum game," in which many countries can benefit at the same time. The central international agreement created at the urging of the United States to assure that this theoretical assumption would, in fact, fit real trade conditions is the General Agreement on Tariffs and Trade, known as the GATT. Often referred to loosely as "international trading system," the GATT establishes rules and principles to keep the trade playing field level.

GATT membership, since 1947, has grown from 23 to 90 countries, accounting for over four-fifths of world trade today. Since the GATT's creation, trade has flourished, with world exports now approaching $2 trillion. This growth in trade has contributed to important national goals; namely, economic growth and higher real incomes and wages.

But, despite the growth in trade and the higher standard of living it has brought, the survival of the international trading system is now in question. One by one, the founding principles of the trading system have been shaken by developments inside and outside the GATT. Today, the unprecedented U.S. trade deficit, $123 billion in 1984, the high value of the dollar, and other international financial developments place the trading system in further jeopardy. Despite the current strong recovery in the United States, protectionist pressures continue to be strong.

This chapter assesses the current condition of the international trading system, and it recommends a U.S. policy response. Section 1 describes the key principles and premises of the GATT which have formed the basis for cooperative trade relations since World War II. Section 2 examines the divergence between real trade conditions and these principles and premises. Section 3 provides a look at other economic and political developments—called "pro trade countertrends"—which bolster the trading system. In Sections 4 and 5, policy choices are reviewed.

The intent of this chapter is to contribute to the congressional trade debate by providing a broader view of the prospects for the international trading system. The discussion here builds on information developed during a series of hearings sponsored by Senator Roth in the last session of Congress on "How To Save the International Trading System." There already has been much public focus on the erosion of the GATT system. Daily press reports highlight new trade distortions and restrictions and unfair trade complaints. But there has been little public discussion of other economic and political developments—the pro trade countertrends—which are providing new underpinnings for cooperative trade relations.

It is not surprising that this lopsided view of developments in the world economy has fostered a number of policy proposals—protectionism, import surcharges, export subsidies, industrial policy, regional trade blocs—which, in the long term are counterproductive to U.S. and world trade interests. From a more balanced perspective, the relevance of these self-defeating proposals fades, and a more promising trade policy for the United States emerges.

The Administration and the Congress should support a strong U.S. leadership role in saving the international trading system. In Section 5 of this chapter, three areas are outlined that should receive the bulk of congressional attention. These areas are: (1) objectives for new multilateral trade negotiations, (2) costs and benefits to the United States of seeking GATT reform, and (3) domestic economic measures, both macroeconomic and microeconomic, to support trade expansion. Resolution of issues in each of these three areas is critical to building the domestic consensus on trade that can put the United States at the forefront of an international effort to save the international trading system and thereby promote both U.S. and global economic growth.

PRINCIPLES AND PREMISES—THE FOUNDATION OF THE INTERNATIONAL TRADING SYSTEM

The survival of the international trading system refers to, in general, the survival of cooperative trade relations between nations. More specifically, reference is to the key principles and premises of the GATT which have formed the basis for cooperative trade relations since World War II. A brief description of these fundamental concepts is provided below.

Multilateralism

Multilateralism refers to trade arrangements which are built on negotiations among all nations multilaterally. Multilateralism (as opposed to bilateralism or other partial arrangements) is preferred because it speeds the process of trade liberalization and, thus, more quickly brings a higher living standard to all participants. Multilateralism also tends to reduce trade frictions among countries.

Nondiscrimination

This principle is embodied in the "most favored nation" (MFN) clause. Under this principle, all members of the GATT are bound to grant, to each other, treatment as favorable as they give to any country in the application and administration of import and export duties and charges. Thus, no country is to give special trading advantages to another; all are on an equal basis and all share the benefits of any moves toward lower trade barriers.

This principle also is embodied in another important GATT concept, "national treatment." National treatment means that imported products will receive equal treatment (to domestic products) in regard to the application of law, regulations, and taxes.

Transparency and Binding of Tariffs

These two principles of GATT are intended to provide a stable and predictable basis for trade. Transparency means that protection, when it is necessary, should be in the form of customs tariffs, rather than other protective measures, such as quotas. Binding of tariffs means that members guarantee that their negotiated tariff rates (bound tariff) will not be changed without consultation and compensation to other members.

Reciprocity

The reduction of trade barriers has to be carried out by a bargaining process in which every participant thought it obtained advantages that were as good or better than whatever concession it had to make others. Although the word reciprocity does not appear in the GATT, the GATT establishes detailed procedures for assuring a broad balance of advantages among signatories.

Negotiation of Trade Disputes

The commitment by GATT members to consultations for settling trade disputes is another fundamental principle of the GATT. Under the agreement, countries, large and small, can call on the GATT for settlement of cases in which they feel their rights under the General Agreement are being withheld or compromised by other members.

The Free Market

Free trade theory was foremost in the minds of the GATT draftsmen and is reflected in the GATT's general orientation toward a market economy. The Agreement is based on the assumption that most trade will be conducted by private interests in markets in which prices are established by a free interplay of supply and demand. Provisions in the GATT are based on the premise that, by reducing government interference in the transactions of private traders, there will be a better allocation of resources and increased economic welfare of all participants.

It is clear from even a cursory review of these trading principles that the GATT founders, led by the United States, were not ivory-tower ideologues. With the experience of the 1930's behind them, they were committed to trade expansion. But they knew that trade would flourish only within a world trading system that provided both fairer and freer trade. Principles like multilateralism and transparency were designed to free up trade; others like nondiscrimination and reciprocity were designed to ensure trade equity among signatories. The provisions for consultations and negotiations were included to assure that the system worked over time.

PRACTICE—THE DIVERGENCE BETWEEN THE REAL WORLD OF TRADE AND THE TRADING SYSTEM

The principles and premises of the GATT, outlined above, ostensibly govern nearly all the world's trade today. GATT membership has grown from 23 countries in 1947 to 90 countries today. Together, these countries account for more than four-fifths of world merchandise trade. GATT principles and premises, however, have been eroded by unforeseen developments both within the GATT and in the world economy.

Trade Outside Standard GATT Rules

Major segments of trade now are not effectively governed by the basic rules of the trading system.

Agriculture was the first sector in this now broad category. It was the United States which, in the 1950's, led the movement to remove most agriculture products from the purview of GATT. In the 1960's, the European Community followed suit with its even more extensive Common Agricultural Policy.

Agriculture trade, alone, accounts for about 12.5 percent of world trade. But it is not the only major trade sector operating outside the mainstream of GATT rules and negotiations. Other such sectors include textiles and clothing, shipbuilding, steel, and automobiles. It is estimated that from 40 to 48 percent of world trade is conducted under trade restraints, other than tariffs, and that 90 percent of such restraints have been taken outside the GATT process, for example, through voluntary restraint agreements.

Important new trade areas also fall outside the GATT system. Services trade is of significant and growing importance to the United States, yet presently the GATT deals essentially with trade in goods only. Trade in services account for roughly one-fourth of world trade in goods and services. Moreover, high technology industries are also of increasing importance to the United States and GATT rules do not adequately deal with the special trade conditions in this sector.

"New" trade practices fall outside the system as well. Countertrade (barter, offsets, etc.) is of growing importance. GATT rules are not easily applied to trade that does not involve the exchange of currency for goods. Yet, with the international debt problems, countertrade is flourishing. It is estimated that countertrade accounts for roughly 20 to 25 percent of world trade.

Last, although most U.S. trade continues to be conducted with GATT members, a growing volume is now accounted for by nonmembers. For example, in 1983, nonmember Mexico was our fourth largest trading partner. Trade with other nonmembers, such as China, the Soviet Union, and Saudi Arabia is also substantial.

Exceptions to the Principle of Nondiscrimination

Within the GATT, the principle of nondiscrimination has been compromised repeatedly. Although the GATT provides for exceptions from nondiscriminatory trade for regional trade arrangements, most commentators agree that the GATT founders did not foresee the extent to which regional arrangements would spread. In the 1950's, establishment of the European Community (EC) was seen as a major deviation from the GATT system. Today, regional trade arrangements include the EC, the European Free Trade Association, and the Latin American Free Trade Area. Special trading arrangements also exist between the European countries and many of their former colonies. International trade within the three major trading blocs alone accounted for roughly $320 billion in 1983. Moreover, new authority now exists for the United States to negotiate bilateral or regional trade arrangements.

The MFN concept has been eroded further in the GATT by the development of special provisions for less developed countries. Although most of these countries do belong to the GATT, these special provisions allow them to circumvent much of the GATT system. Less developed countries (LDC's) are no longer a minor factor in world trade. In 1983, LDC's accounted for 30 percent of world exports, 38 percent of U.S. exports, and 41 percent of U.S. imports.

Special rules also have been developed within the GATT to deal with new communist participants. Today, there are six communist signatories of the Agreement: Cuba, Czechoslovakia, Hungary, Poland, Romania, and Yugoslavia. Trade by these communist signatories accounts for only 2.2 percent of world exports. However, Chinese and Soviet interest in the GATT means that this issue may be a continuing pressure on the system.

New Trade Distortions

The successful reductions of tariffs in the GATT has revealed the importance of nontariff barriers to trade and, ironically, is encouraging governments to increase the use of these other forms of protection. Trade restrictions are fungible.

For example, there is the increasing use of performance requirements on investments. These requirements sometimes allow investment only if the investor promises to export a certain percentage of production. In other instances, the commitment may concern imports, with the investor undertaking to buy certain supplies locally.

New Roles for Government in the Economy

Since the market-based GATT was formed, capitalism in Western Europe has changed significantly. In some countries, state-owned companies now amount to nearly half of the industrial sector, including control of key industries. European governments now have a direct ownership stake in over half of Europe's 50 largest companies. In addition, other countries in which government ownership is important now play an increasingly important role in trade.

Profits generally are not the major goal of State-owned firms and, thus, the basic GATT rules premised on profit-motivated traders do not fit the new trade realities. Nationalized companies can easily implement nontransparent protectionist measures.

Like government ownership, other State strategies also threaten GATT. Principal among these are comprehensive activities by various governments to restructure their economies, often referred to as targeting. Targeting refers to government activities to either create a competitive advantage in a specific industrial sector or to manage surplus capacity and the transition out of other industrial sectors.

The GATT assumes that the State would simply umpire the economic rules while leaving the economic outcomes to market competition. Thus, current trade rules cannot adequately deal with government targeting.

Japan, the United States' second largest trading partner, has been the most noted practitioner of targeting. The practice is widespread in Europe, as well, and increasing in the developing countries, particularly those in the Pacific Basin.

PROSPECTS—THE EMERGENCE OF PRO TRADE COUNTERTRENDS

This examination of the gap between current trading conditions and GATT principles and premises leaves the impression that the trading system is near collapse. This pessimistic view seems further justified in light of additional pressures created by the United State's unprecedented trade deficit, the high value of the dollar, and other international financial developments.

But a negative prognosis on the fate of the trading system is premature. While it is true that some changes in the world economy have seriously eroded the trading system, other economic and political developments—pro trade countertrends—now support broader international cooperation and bolster the GATT as an institution. Key among these are: the growth of trade, new organized support for trade, trends in international business, the international debt situation, certain political developments, here and abroad, and positive trends within the trading system itself.

Growth of Trade

Since the GATT was founded, world trade has increased every year except 1952, 1958, 1981, and 1982. During most of this period, trade rose at a substantially faster rate than world production. Today, the value of trade on the world export market has approached $2 trillion.

This growth of trade and the division of labor it implies have brought the benefits that trade theory promises: a higher standard of living, lower inflation, and increased productivity. These positive results of trade have not been lost on their American beneficiaries.

The magnitude of this trade expansion has spawned new organized support for trade and for cooperative trade relations. The support for trade has long come from consumer advocates, and is now bolstered by well-financed activities of major importers, retailers, and business users of imported goods who indirectly represent the consumer interest as well as by the growing political presence of major exporters. With more interest groups following trade developments, there is also more information before the public on the costs of protectionism.

Business Trends

Key trends in business support the survival of the trading system. A several decade-old trend toward the formation of multinational corporations and the more recent trend toward the internationalization of production (i.e., product parts being produced in several countries) continues. Both of these developments foster trade and encourage cooperative trade relations.

Another business development which affects the prognosis for the trading system is the trend toward diversified production in American corporations. One result of the merger phenomenon in this country is that many companies now produce a broad range of products. This means that their trade interests are mixed. In some lines, these corporations face competition from imports; for others, they need imported components; and, in still others, they need export sales and open markets abroad. The tendency is for these mixed interests to lessen the protectionist pressure in this country.

A final and recent business trend that bodes well for the trading system is the major effort now underway in corporate America to strive for advances in industrial competitiveness. The results of this effort are already beginning to show in increasing productivity. A stronger U.S. competitive position will make even more clear the need for world markets and economic cooperation.

International Debt

The level of LDC debt and the strain it puts on the international banking system are most frequently cited as a threat to international economic order. However, there is a countertrend to these developments as well. The debt problems graphically demonstrate the counterproductiveness of protectionism. Should the United States close its markets, LDC's cannot sell in U.S. markets and their debts cannot be paid. The stability of the banking system would be threatened. Ironically, in this way, the debt problems of LDC's strengthen, rather than weaken, the prospects for survival of the trading system.

Political Developments

Two political developments stand out as particularly hopeful. The first is the growing sensitivity to the cost of government. There is renewed interest in Europe and third world countries in the free market principle. Government ownership in some countries is now shrinking, and the extraordinary financial burden of major export subsidy programs is receiving increasing public scrutiny. These developments improve the prospects for curbing the increase in new trade distortions.

Second, new sources for world trade leadership may be developing. With the trading system in serious trouble, other countries will be taking a serious look at their stake in its survival and at the effort they need to undertake to make it function effectively. Japan has made such an assessment and has started to focus public attention on rebuilding the trading system.

Positive Signs in the Trading System

Probably never before has the GATT system been both so abused and used. An assessment of the status of the trading system would, in fact, be distorted if it did not highlight the latter point.

There has been an increased use of the GATT consultation and dispute-settlement procedures, although the value of these mechanisms to date is open to debate. The most significant positive trend in the effectiveness of international trade rules has been in the domestic implementation of GATT agreements concerning dumping and subsidies. Four years ago, there were only nine cases brought in this country against foreign subsidized competition. Since that time, there have been several hundred cases. There has also been a substantial increase in cases brought against foreign dumping in U.S. markets. One reason so many cases have been filed is due to rising protectionist sentiment. But this reason should not obscure the fact that more cases have been filed because our U.S. domestic trade laws are working. These laws are linked to international trade agreements. Thus, if fairly implemented, they provide redress against unfair trade without risking retaliation against American exports.

Last, the trading system has not been static. There have been seven rounds of trade negotiations since the GATT was formed. While tariffs were the primary focus of the first six rounds, the last negotiations—the Tokyo Round (1974 to 1979)—began to address other, nontariff distortions to trade.

Perhaps an accurate assessment of the status of the trading system is that, rather than being in near collapse, it is at a crossroads. U.S. trade policy decisions in the next few years will be instrumental in determining the fate of the international trading system.

POLICY PROPOSALS—FROM CLASSIC PROTECTIONISM TO REGIONAL TRADE BLOCS

The divergence between real trade conditions and trade theory has stimulated a creative reexamination of the tenets of U.S. trade policy. The caldron of ideas is bubbling—and this is a good sign. But there is concern about the direction of these proposals. To date, the key ideas that have risen to the surface fall into five categories, all of which would severely constrain the prospects of trade: (1) classic protectionism; (2) import surcharges; (3) aggressive export subsidy strategies; (4) industrial policy; and (5) regional trade blocs.

Classic Protectionism

A traditional response to trade frictions (or even to trade competitiveness) is to erect a wall of protectionism around domestic industries.

Those seeking protection do not see trade as a "positive sum game." They see trade as a "zero sum game" in which one country's advantage can only be secured at the expense of another's. They offer proposals for new trade barriers as a means to bring the most advantage to the United States.

There is no advantage to be gained by protectionism. Protectionism would deny the United States the productivity and deflationary benefits of imports and, at the same time, it would limit export sales, as other countries close their borders to respond-in-kind to U.S. trade restrictions. Moreover, protectionism would do nothing to counter the unfair trade practices American exporters face overseas; in fact, it would lessen the chances of stopping these practices by creating increased trade frictions with other countries.

Most significant, although the pressures for protectionism arise from the magnitude of our trade deficit, growing protectionism in this country would limit world economic recovery. World recovery is a key to substantially reducing the U.S. trade deficit.

It is broadly believed that the U.S. trade deficit stems largely from three factors: the high value of the dollar, reduced exports to LDC debtor countries, and the United States' superior economic performance compared to that of its trading partners. Better economic performance abroad would shift each of these factors: it would encourage foreigners to keep more of their capital in their own countries and, thus, lower the value of the dollar by lowering the demand for dollars for investment in this country; and it would help revive LDC markets for U.S. exports. Should the economic performance of other trading nations improve relative to the performance of U.S. economy, U.S. exports to developed countries would expand.

Other countries are now dependent on the U.S. market to secure their economic recoveries. Avoiding protectionism is not a matter of altruism for the United States, it is a matter of self-interest.

Import Surcharges

Recently, proposals have surfaced suggesting that the United States should place a new, temporary duty of 10 to 20 percent on imports for a period of three years—the so-called "import surcharge."

This idea is distinguished from classic protectionism in that there is only one precedent of the imposition of an import surcharge, however, by the United States. An import surcharge presents all the drawbacks of other protectionist proposals, only to a greater degree since the scope of the trade restrictive action would be broader than restrictions on particular protected products.

The most serious danger of imposing an import surcharge is that it, like the more classic forms of protectionism, would choke off the world economic recovery that now promises to narrow the trade deficit.

Ironically, the surcharge is offered as a short-cut means to narrow the U.S. trade deficit by lowering the volume of imports. But this narrow view assumes that an import surcharge would not affect our export volume.

A surcharge, however, will likely affect the level of exports. A surcharge would unleash three new developments which would hurt export sales. First, by lowering the volume of imports, a surcharge would lower the volume of dollars in world markets. With less dollars available, demand for dollars would push the dollar higher on exchange markets. Second, the additional duty on imports would raise domestic prices. This would increase interest rates, if there were no concomitant change in the money supply. The higher interest rates would pull more capital into the United States, again pushing the dollar higher on exchange markets. Third, the increase in domestic prices would also increase the basic price of our exports. The appreciation of the dollar and the increase in export prices would lead to a decline in exports.

An import surcharge, although preferred as a ready answer to the appreciation of the dollar and the U.S. trade deficit, would only exacerbate U.S. exchange rate problems without necessarily narrowing the trade deficit.

Aggressive Export Subsidy Strategies

Some advocate the aggressive use of export subsidies by the U.S. Government to promote the performance of particular domestic industries in world markets. They would have the United States go beyond the use of an occasional defensive subsidy action to encourage better behavior by trading partners.

A "subsidy race" is not the right answer to the divergence between trade practices and trade theory. First, there is the issue of cost. Either money would have to be diverted from other uses or new revenues would be needed to finance the subsidy program.

Even if money were readily available, how effective would an ambitious export subsidy program by the United States be? Aggressive export subsidy schemes could only be effective if (1) the government had the knowledge to discern the most promising industries to subsidize; (2) the subsidies helped produce new export sales, not just sales that the industry would have made anyway; (3) the profit from the subsidized sales exceeded the cost of the subsidies; (4) the subsidies did not simply shift production out of the domestic market rather than adding new production for exports; and (5) other countries did not retaliate against U.S. exports, or raise their own subsidy levels to match those established by this country. It is doubtful that all these conditions could be met.

Aggressive subsidy policies would inevitably increase government intervention in the marketplace. The result is likely to be an economy marked by subsidized stagnation, rather than competitive dynamism.

Industrial Policy

Industrial policy not only refers to an assessment of the effects of current government policies on the performance of domestic industry, but includes also the creation of new government institutions (e.g., industrial strategy councils or an industrial bank) with the authority to shape the industrial structure of the economy of the United States.

With industrial policy, the government would, in essence, pick industry "winners and losers." To do this, political judgment would likely take the place of the economic forces of the marketplace. In the trade area, this is likely to mean two things: more protectionism and more subsidies.

The broad issue of industrial policy was the subject of extensive hearings by the Joint Economic Committee in 1983. Based on those hearings, the Committee staff prepared a study entitled "Industrial Policy Movement in the United States: Is It the Answer?" (Senate Print 98-196, 98th Congress, 2d Session, June 1984.)

Adjustments to micro policies, other than trade, which affect our industrial competitiveness, such as antitrust and regulatory policies, can be made in the process of creating an economic environment for growth. It seems that the rationale for creation of a special industrial policy relates to an interest in changing our trade policies—and changing them in a direction which would be detrimental to U.S. as well as global economic growth.

Regional Trade Blocs

It has been suggested that the United States might need to abandon its traditional support for multilateral trade and organize itself instead for a world of regional trading blocs. The specific trading bloc proposed for the United States would be comprised of Canada, major Latin American countries, and probably Australia and New Zealand.

Perhaps the most potent criticism of this proposal is that it is based on a flawed presumption: this proposal presumes that it would be easier to establish "free and fair" trade within regional trade blocs than through multilateral negotiations. It us unlikely that non-tariff-trade barriers and trade distortions, caused by government intervention in economies abroad, would be any easier to resolve on a regional basis. Actually, any such trade problems that could be resolved regionally could likely be resolved multilaterally, and the rationale for regional trade blocs would be moot.

Embracing trading blocs would result in a less efficient allocation of productive resources, less economic growth, and a lower standard of living.

In the final analysis, each of the five proposals discussed above is a varient of the first—protectionism—because each would, in the end, foster trade restrictions, rather than trade expansion. Since 1934, the United States has rejected trade policies which foster trade restrictions and has led the world in efforts to expand trade. The tremendous growth in international trade strongly suggests that this has been a wise course.

POSITIVE RESPONSE—AN AGENDA FOR U.S. LEADERSHIP TO SAVE THE TRADING SYSTEM

Each of the policy proposals discussed so far—classic protectionism, import surcharges, aggressive export subsidy strategies, industrial policy, regional trade blocs—is mistaken because each is based on a lopsided short-run view of the world economy, present and future. These reactionary proposals are a response to the forces eroding the trading system. However, they do not take into account the counterforces—the pro-trade trends—which provide new and stronger underpinnings for the international trade system and world economy. Protectionist trade policies would speed the erosion of the international trade system.

Rather than contribute to trade stagnation and economic decline through the use of protectionism, the United States should lead a major international effort to strengthen the international trading system. This effort rests on a comprehensive and realistic view of current trade conditions and future trade prospects. It makes use of the positive forces in the world economy to transform the international trading system into an institution that can, in fact, yield gains for all participants. The choice is to either promote trade expansion and the economic prosperity it brings, or yield to trade restrictions and the contraction of growth that is sure to follow.

Unfortunately, the United States may not be ready to initiate a bold attempt to save the trading system. It is not ready because, today, there is no clear consensus in this country on trade policy.

A principal task of the 99th Congress should be to form that consensus and, thereby, lay the groundwork for U.S. leadership to save and strengthen the trading system. The Congress can help build the necessary consensus in this country to support new international trade initiatives by furthering public discussion in three areas: (1) the need to identify objectives for new multilateral trade negotiations, (2) the quantification of the costs and benefits to the United States in seeking GATT reform, and (3) the development and promotion of domestic economic measures that support trade expansion. This agenda for congressional trade action is discussed below.

Objectives for New Multilateral Trade Negotiations

The first prerequisite for U.S. action to strengthen the trading system is a broad public discussion to determine the full scope of objectives the United States should pursue in new negotiations to revitalize the GATT.

The GATT became the world's governing body for trade by default, not design. Originally, the International Trade Organization (ITO) was to be the third pillar of the postwar international economic system, along with the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank). The ITO, however, was never organized, and the GATT, which was conceived as a trade agreement, not a trade institution, was created to fill the void. Although the GATT has evolved over time, its effectiveness is still hampered by the fact that it was never designed to do what is now expected of it.

Thus, while the impetus for reform of the trading system appears on the surface to be specific sectoral or bilateral trade frictions, the inability of the trading system to contain these frictions may actually relate to the need for broad institutional reforms. It is, therefore, important that public debate on ways to reform the GATT include the institutional issue.

There are two key institutional issues: those that relate to GATT organization and those that relate to the scope of the current agreement. Regarding organization, consideration needs to be given to (1) new authority for the Director-General; (2) new committees to broaden the purpose of the GATT from a strictly judicial to a policymaking role (e.g., formation of a committee charged with anticipating trade adjustment measures); (3) new ways to strengthen GATT dispute settlement processes (e.g., such as time limits similar to those in our domestic trade law); (4) new arrangements on safeguard actions used to limit imports on a temporary basis; and (5) new institutional links between the GATT and the international financial institutions (IMF and World Bank). In addition, the GATT should be broadened to cover new trade or trade-related issues including investment, intellectual property rights, services, specific high technology trade issues, and the complex issues involved in government intervention practices. A concerted effort needs to be made to bring all areas of trade (agriculture, LDC's, etc.) more fully within the system.

Costs and Benefits

The benefits of trade have, for a long time, been unquestioned. However, in the last few years, the trade deficit and increased protectionist pressures have reopened this issue. A prerequisite for new U.S. action to strengthen the trading system is a new consensus and commitment in this country in favor of trade.

Also, a realistic assessment of the costs of strengthening the trade system needs to be made. For example, the fact that agricultural trade is now largely outside the trade rules has caused many trade problems: European subsidy practices have limited U.S. sales in that market and in third country markets, and Japan has continued to restrict our access to its agricultural market. However, those markets will not be opened voluntarily or unilaterally without a quid pro quo from the United States. The United States has a special right to waive GATT rules to implement quotas on certain agricultural imports and, right now, is using this to restrict imports on several commodities including dairy products, certain cotton, and peanuts. This waiver right may need to be sacrificed in any new negotiations to strengthen the trading system. And this is only one example; a full assessment of the price tag for saving the trading system must be determined.

Finally the trade implications of domestic policy actions must not be overlooked. This year, for example, Congress will be considering a new farm bill. The trade implications of changes in the farm program need to be considered during the debate on the farm bill. Trade-enhancing changes in the farm program could provide important leverage for enticing U.S. trading partners to join in an effort to strengthen the trading system for agriculture.

Domestic Economic Measures To Support Trade Expansion

Another way in which the Congress can assist in laying the groundwork for a new American initiative for trade expansion is to support policies which sustain economic growth in this country and bolster the competitiveness of domestic industries. The full range of such policies, both microeconomic and macroeconomic, are discussed in other chapters of this report.

There are two special microeconomic issues with particularly direct links to the prospects for a U.S. initiative to save and strengthen the trading system. The first issue concerns trade adjustment assistance. The Trade Adjustment Assistance program is before the Congress for action this year. An effective adjustment assistance program is a fundamental component of a trade policy which supports trade expansion. Recognizing budgetary constraints, the Congress needs to fully explore the possibilities for a revamped program which emphasizes adjustment through retraining and builds on the private sector/public sector relationship now developing through the Job Training Partnership Act.

The second issue relates to proposals for reorganization of the trade bureaucracy, also before the Congress this session. The management flaws of the current U.S. trade policymaking structure are serious and merit evaluation. A more rational organization of the trade bureaucracy should facilitate the development of a domestic consensus on trade policy and also provide more effective staffing for a new U.S. initiative to strengthen the trading system. Any trade reorganization should be carefully crafted to avoid starting down a path of industrial policy or centralized planning.

CONCLUSION

Changes in the world economy—increased interdependence, new technologies, more and better competition from other countries, and rapidly shifting comparative advantage—present opportunities, as well as perils, for the United States. It has become commonplace to cite the perils that these changes portend for the United States: rising unemployment, increasing dependence on other countries for certain commodities, a challenge to the integrity of our banking system, and a net decline in our standard of living. Missing from this public discussion, however, is the recognition of the opportunities created by the new world economy: new products, new production processes, new markets, and the mingling of ideas across national borders could produce a higher standard of living as the world moves into the 21st century.

Whether the world is on the threshold of an era of new achievements, or on a serious downward spiral into economic isolationism, depends, in large part, on how the United States decides to grapple with the future. A major U.S. initiative and commitment to save the international trading system is one way to help assure that the United States can successfully meet these economic challenges.

Chapter VIII. THE AGRICULTURAL AND RURAL ECONOMY

INTRODUCTION

Following what many experts have judged the worst recession since the Great Depression, the U.S. economy experienced initially rapid, and now sustainable, growth. Since the recession ended in November 1982, the coincident index of economic indicators has risen 20 percent. Between the fourth quarter of 1982 and the fourth quarter of 1984, real gross national product climbed 12 percent; real gross private domestic investment was up 63 percent; and corporate profits, before taxes, increased 92 percent. During the first two years of the recovery, over seven million jobs were created and industrial production as of December 1984 was 22 percent greater than in November 1982. Production of business equipment was up 30 percent, construction supplies up 29 percent, motor vehicles and parts up 69 percent, and even the production of iron and steel has risen 58 percent. From November 1982 to December 1984, new construction expenditures increased 26 percent. During 1984, a total of 1.75 million new private housing units were started, up 64 percent from the 1.07 million units started in 1982. Reagan Administration economic policies have set a new standard for economic recoveries.

But things are different down on, and around, the farm. Since the fall of 1982, when the economic recovery began, total farm production expenses have increased $3.1 billion while total farm cash marketing receipts rose but $500 million. According to Department of Agriculture forecasts, farm production costs will equal farm cash marketing revenues in 1984. Therefore, the Department's net farm income forecast of $31 billion for 1984 is composed of the value of inventory change ($8 billion), nonmoney income (value of home consumption of farm products and imputed rental value of farm dwellings, $13 billion), other cash income (income from custom work, machine hire, and farm recreational activities, $2 billion), and direct government payments ($8 billion). After a full year of national economic recovery, in 1983, nonfarm proprietor's income increased 21 percent while farm proprietor's income fell by 36.7 percent.

Capital expenditures in agriculture have remained virtually unchanged since 1982; agricultural employment has declined by almost 100,000 jobs; prices received by farmers have risen but 3 percent (or fallen 4 percent relative to the GNP deflator); and farm equity has fallen by almost $64 billion. The volume of U.S. agricultural exports has declined for four consecutive years. President Reagan has acknowledged the fact on several occasions that this Nation's largest and oldest industry remains in economic recession.

There is, of course, a very strong linkage between agriculture and the rural economy. Not only does the farm sector create activity through the purchase of agricultural inputs, but also through the purchase of goods and services for household consumption. In contrast to the expansionary decade of the 1970's, farms—as businesses and as family units—recently have had to modify their operating budgets to accommodate the stringent financial situation of agriculture. As a consequence, the rural economy, by and large, has inherited the same misfortune as the agricultural economy in the 1980's.

THE CHANGED RURAL ECONOMY

Rural areas have not participated fully in the post-1982 recovery. A more complete picture of the rural economy is necessary to reveal the nature, depth, and complexity of the economic problems rural areas are currently facing and are likely to face for years to come. Many rural localities have been in recession since 1979. Other communities fortunate enough to have participated in the recoveries of 1980–1981 and 1983–1984 probably witnessed a dramatic slowdown in economic growth compared to the 1970's. Among the underlying factors affecting rural economic performance are (1) structural and economic changes in agriculture and other extractive industries such as lumber and minerals, (2) adjustments in the nonagricultural rural economy, (3) population and other demographic shifts, and (4) changes in the macroeconomy and the association of the rural economy to it. These components have important long-term ramifications over and above the short-term climate of the rural business environment.

The farm sector is and always has been responsive to innovation. Farming techniques have changed dramatically, resulting in reduced manpower requirements and larger scale farming. Local business economies are affected in two ways. First, excess farm labor unable to find local employment exits rural areas in search of alternative employment opportunities. Consequently, local businesses face a decrease in demand for their services.

Second, many large-scale farms buy directly from suppliers and manufacturers. Large volume purchases often entitle farmers to factory discounts and premiums, but at the expense of eliminating the "middleman" (i.e., the local businesssman). Large farms also tend to be self-sufficient in providing the services required for operations, diminishing the demand for services from off-farm sources. Thus, fewer farm families and the reduced demands of large farms create a long-term challenge to the economic viability of traditional rural communities. Combined with the current frugality of farms experiencing financial trouble, these changes in agriculture are inducing radical adjustments in the entire rural economy.

Prior to the late 1960's, surplus rural labor migrated to the cities in large numbers. After that time, however, rural areas experienced a rekindling of sorts when nonagricultural employment opportunities arose. The overall expansion of the U.S. economy provided an incentive for industries to increase production and facilities, and many firms took advantage of the highly trainable, productive, and lower cost rural labor supply of rural communities. Higher employment in these new primary industries also precipitated higher employment in supportive services as well. By 1980, about 50 percent of all nonmetropolitan jobs were in manufacturing or services. In all, six in ten jobs now are nonagricultural.

New employment opportunities, while positive on the whole, create problems as well. During the contractionary periods of business cycles, temporary layoffs disrupt income flows of rural families who have become increasingly reliant on these new sources. The reduced spending power of these families can ripple through an entire locality. The financial footing of many rural industries is not as diversified or extensive as the larger and established urban industries. Consequently, some do not have the capability to survive recessions, extended economic stagnation, and uncertainties such as inflation, all of which marred the U.S. economy from the mid-1970's to 1981.

In the wake of these economic problems, the rural economy withered. In the three years 1980, 1981, and 1982, nonmetropolitan employment fell by 580,000 jobs. In contrast, metropolitan employment increased by 180,000 in the same period. Even during better times, rural areas have not kept pace with cities. In only three years in the last 14 have rural areas fared proportionately better than metropolitan areas in changes in employment.

The entire United States is experiencing population and demographic shifts, but they are not uniform. For the first time this century, the nonmetropolitan population grew faster than the metropolitan between the 1970 and 1980 censuses. That trend appears to have reversed back to its historical track, however, beginning late in the decade. The prolonged rural recession beginning in 1980 solidified that reversal as urban outmigration to rural areas was stemmed.

Even more significant is the distribution of population shifts. While overall nonmetropolitan and metropolitan populations have both increased since 1980, over 800 counties—one-fourth of all—experienced declines. In 1983, just 20 States had a larger nonmetropolitan population than metropolitan. These rural-dominant States have just 17.4 percent of total U.S. population. Equally disturbing, these rural States generate only 15.6 percent of total personal income.

Nonmetropolitan areas consist of about 98 percent of the land area of the United States, yet have only 28.5 percent of the population and 24.7 percent of the labor force, and account for just 19.6 percent of personal income. The following table compares metropolitan and nonmetropolitan areas, using the Census Bureau's standard metropolitan statistical areas.

TABLE VIII.1.—METROPOLITAN AND NONMETROPOLITAN STATISTICS (1984)

	Non-SMSA	SMSA
Population (millions)	67.5	169.5
Employment [1] (millions)	23.1	70.3
Personal income (dollars in billions)	722.9	2,958.0

[1] Establishment Data.

Source: Bureau of the Census, U.S. Department of Commerce.

Rural areas generate less income than urban areas. In 1983, median nonmetropolitan family income was $20,938; for metropolitan families it was $26,488, or 27 percent higher. Contrary to popular opinion, lower living costs do not compensate for this difference. In fact, increasing energy, transportation, and housing costs have placed a significant burden on rural households. Incidence of poverty in rural areas exceeds urban areas. In 1983, 18.3 percent of the nonmetropolitan population and 13.8 percent of the metropolitan population fell below the poverty level. The rural population tends to be older, too. Rural States tend to have both higher median ages and a higher proportion of persons over age 65.

The income gap between rural and urban incomes has consistently and continuously widened in the past 15 years. In addition, rural per capita personal income appears to lag behind urban income by about six years. In 1970, metropolitan per capita income was about $5,300; only in 1976 did the rural figure reach that amount. The metropolitan income figure in 1978 was about $10,700, which was achieved in nonmetropolitan areas in 1984. In that year, nonmetropolitan per capita personal income was about 39 percent lower than metropolitan income. The following table traces metropolitan and nonmetropolitan income since 1970.

TABLE VIII.2.—PERSONAL INCOME PER CAPITA

[Nominal dollars]

Year	SMSA	Non-SMSA	Difference
1970	5,336	3,181	−2,155
1971	5,656	3,389	−2,267
1972	6,146	3,714	−2,432
1973	6,834	4,280	−2,554
1974	7,445	4,600	−2,845
1975	8,011	4,923	−3,088
1976	8,749	5,321	−3,428
1977	9,615	5,823	−3,792
1978	10,720	6,508	−4,212
1979	11,952	7,265	−4,687
1980	13,136	7,869	−5,267
1981	14,635	8,843	−5,792
1982	15,354	9,191	−6,163
1983	16,152	9,640	−6,512
1984 [1]	17,450	10,717	−6,733

[1] Preliminary.

Source: U.S. Department of Commerce.

The rural economy's connection to the rest of the U.S. economy—and the world economy for that matter—presents yet another challenge. The domestic economy is transforming from a manufacturing base to services. In addition, the emergence of the information sector as a growing and even dominant economic force is altering the way Americans work and live. In this setting, the rural economy is facing an identity crisis of sorts.

It is apparent that agriculture, forestry, mining, and other activities involving raw materials, which comprise much of the rural economy, are a shrinking portion of total U.S. economic activity and no longer can sustain the rural economic base. Without adding labor and product value to raw materials, rural areas may not be able to sustain economic viability and to overcome deficiencies.

However defeatist that may sound, it need not spell doom for seemingly economically obsolete communities. A changing and dynamic economy creates a steady stream of new opportunities. Combining new technologies such as computers and telecommunications can result in new, close links between rural and urban settings, and new jobs for rural residents. An excellent example of successful technical adaptation was a recent transfer of credit card operations of a major U.S. bank from New York to South Dakota. The bank experienced such impressive productivity gains from their new employees that the facility has been expanded and activities diversified. Other service industries and rural states also could take advantage of using new technology to produce positive and profitable ventures.

Rural areas no longer are immune from swings in the business cycle or other macroeconomic changes. Deregulation of major industries such as transportation and banking also subjected rural areas to abrupt changes in market conditions. The effect of huge Federal deficits on interest rates and exchange rates is felt by farmers and rural businesses. Budget cuts can fall disproportionately on rural residents whose political influence base may be diminishing. Coupled with federalism, many State and local governments are saddled with increased responsibilities and reduced resources to accomplish public goals. These are but a few of the changing macroeconomic factors which impact on rural areas.

This description of lagging income, slower or even negative population growth, lackluster employment opportunities, and the need for a new economic identity reveals a challenging if not problematic horizon for rural areas, especially in light of the evidence that rural areas have not joined in the economic recovery. Economic development requires an accompanying complement of public and private services, such as infrastructure, education, health care, varietal retail commerce, leisure time pursuits, and provision of a host of other business and household needs. Rural areas typically possess the resources and manpower to satisfy or exceed those requirements, all in a setting conducive to safe, secure, and quality living.

The absence of economic recovery in agriculture and rural areas raises many public policy questions. The evidence is very strong that, while traditional Federal programs and approaches to counter economic recession in the agricultural sector may have worked in the past, they have been clearly ineffective in recent times. Public policy has failed to recognize, let alone keep pace with, the structural and economic evolution of agriculture. The public sector, as well as the private sector, needs to consider new approaches to the economic problems and opportunities presented by the rural environment.

ECONOMIC AND STRUCTURAL CHANGE IN AGRICULTURE

Within the span of one generation—20 years—the United States has evolved from a net importer of agricultural products to the largest and most powerful food producer and supplier in the world. Today, roughly one-half of crop farm income comes from the sale of products overseas. Over the last 20 years, the output of U.S. agriculture has doubled while land in farms has fallen 100 million acres, and the number of farms has declined by one-third, farm population by better than one-half, and real net income per farm from farming operations by one-third. Today, more than 70 percent of total farm family income comes from off-farm earnings compared to around 50 percent 20 years ago.

During the decade of the 1970's, total farm production expenses increased 60 percent. However, indicative of the changing nature of farming during this same 10-year period, farm expenses for fertilizer and pesticides and capital depreciation tripled; expenses for petroleum, products, and interest charges quadrupled; and expenses for electricity increased fivefold. It took a century of farming for agriculture to accumulate a real estate debt of $25 billion; then $40 billion more was added during the 1970's. Between 1970 and 1980, the value of assets per farm climbed from $107,000 to $414,0900.

The Department of Commerce recently released its 1982 Census of Agriculture. This census also showed some disturbing trends. While the number of farms declined by less than 1 percent between 1978 and 1982, the number and sales of average-sized farms declined dramatically (Table VIII.3). The number of very small farms—from one to 49 acres—increased by 94,213 and the number of very large farms increased by 1,224. Farms in the middle-size range—from 50 to 1,999 acres—fell by over 112,000. Similarly, farms with annual sales between $5,000 and $100,000 experienced declines in total product sales while very small and larger farms showed increases in annual sales.

TABLE VIII.3.—CENSUS BUREAU FARM CHARACTERISTICS, 1978–1982

	1982		1978		1982/1978	
	Number	Percent	Number	Percent	Change	Percent change
All farms	2,241,124	100.0	2,257,775	100.0	−16,651	−0.7
Land in farms (Acres, 000)	984,755	100.0	1,014,777	100.0	−30,022	−3.0
Average size	439		449		−10	−2.2
Farms by size—Acres:						
1 to 9	187,699	8.4	151,233	6.7	+36,466	+24.1
10 to 49	499,301	20.0	391,544	17.3	+57.747	+14.7
50 to 179	711,701	31.7	759,047	33.6	−47,346	−6.2
180 to 499	526,566	23.5	581,631	25.8	−55,065	−9.5
500 to 999	203,936	9.1	213,209	9.5	−9,273	−4.3
1000 to 1999	97,396	4.4	97,800	4.3	−404	−0.4
2000 +	64,525	2.9	63,301	2.8	+1,224	+1.9
Farms by sales class ($000):						
Under 5	814,897	36.4	762,047	33.7	+52,850	+6.9
5 to 10	281,895	12.6	314,245	13.9	−32,350	−10.3
10 to 20	259,258	11.4	299,421	13.3	−40,163	−13.4
20 to 40	249,063	11.1	299,398	13.3	−50,335	−16.8
40 to 100	333,047	14.9	360,423	16.0	−27,376	−9.1
100 to 200	180,689	8.1	141,926	6.3	+38,763	+27.3
200 to 500	83,891	3.7	62,780	2.8	+21,111	+33.6
500 +	27,800	1.2	17,976	0.8	+9,824	+54.7

Source: Bureau of the Census, U.S. Department of Commerce.

Perhaps the most disturbing trend is the increasing dependence of agriculture on government payments. The often espoused political goal of "getting government out of agriculture" has, to say the least, been unrealized, as the following Table VIII.4 shows:

TABLE VIII.4.—NET FARM CASH INCOME AND GOVERNMENT PAYMENTS

[Dollar amounts in billions]

	Net cash income	Direct Government payments	Payments as percent of net cash
1980	–$37.7	–1.3	3.4
1981	35.0	1.9	5.4
1982	36.8	3.5	9.5
1983	40.1	9.3	23.2
1984 [1]	36.0	8.0	22.2

[1] Midpoint USDA forecasts.

Source: U.S. Department of Agriculture.

Because of this growing and extreme dependency on government payments, farm program budget cutting will be particularly painful for the agricultural sector. Maintaining this degree of dependency, however, is not in the long-term interest of agriculture either.

Large taxpayer costs of farm programs due to food surpluses perhaps properly should be measured against the domestic and global economic, social, and political consequences of the alternative, food shortages. The returns from U.S. agriculture, measured in terms of virtual complete food security, job creation, significant export business, balance of payments, and a host of other positive economic as well as social contributions, need to be accounted for and fully appreciated relative to public expenditures. Even at today's historic high levels, the cost of farm programs represent less than 2 percent of Federal budget outlays and less than one-half of 1 percent of this country's gross national product.

POLICY CONSIDERATIONS FOR A CONTEMPORARY AGRICULTURE

Few major industries have experienced the degree and pace of economic and structural evolution as agriculture. Compared to but 10 years ago, agriculture today is a highly industrialized and increasingly concentrated industry, fully integrated into the national as well as international economy. Two indicators alone—70 percent of farm household income comes from earnings made off the farm and 50 percent of crop income comes from foreign sales—is enough to suggest that agriculture, like the old gray mare, just ain't what she used to be. As a result, monetary and fiscal policies, trade policy, and tax policy, to mention a few, have significant influence on the farm and rural economies. Few sectors of the U.S. economy have been more victimized by high real interest rates and the high foreign exchange value of the dollar than agriculture. Aggressive efforts to significantly reduce the Federal deficit are paramount in achieving economic recovery in agriculture and in rural areas. Federal actions and programs in these areas have been and will continue to be equally important, if not in some instances, more important than farm policy and programs. The predictable, growth-oriented economic, trade, and tax policies, discussed elsewhere in this report, are critical to the financial revitalization of agriculture.

Public and congressional debate of the 1985 farm bill has begun. Early indications from the Reagan Administration suggest its preference for lower price supports and lower per farmer limitations on crop loan and deficiency payments—basically an offering of "less of the same." Other interests have argued that the current economic condition of agriculture calls for higher and greater price and income supports—basically a plea for "more of the same." Yet, others endorse a status quo policy or a continuation of programs contained in the 1981 Farm Act.

According to the Congressional Budget Office, Federal expenditures for Commodity Credit Corporation price-support, payment-in-kind, and related activities over the last four years (fiscal 1981 to fiscal 1984) will exceed $50 billion. This level of expenditure for the last four years is equivalent to the expenditures for these same programs during the previous 20 years combined (1961 to 1980). Federal expenditures for farm credit and export promotion programs are also at record levels. Considering the present economic condition of agriculture, documented earlier, Federal farm policy is not at a crossroads, it's at a dead-end. Doing "the same," "less of the same," or "more of the same" is not in the interest of farmers or taxpayers. The farm policy challenge to the 99th Congress is to do better with less.

The stakes are tremendously high. In addition to agriculture's contribution to gross national product, job creation, and our balance of payments, the U.S. Government extensively uses the products of American farmers to pursue public assistance and foreign policy objectives through food stamp, school lunch, food-for-peace, and other programs. Also, a sizable portion of private and public investment during the last 10 years in food production, processing, marketing, merchandising, and transportation has been in direct response to meeting expanded food and fiber demand. Private-sector enterprises, including millions of farmers, have spent billions of dollars to capture, develop, service, and retain domestic and foreign markets.

U.S. agriculture is at a pivotal point in its history. Our choice of programs and policies for the farm sector—and the whole economy as well—will influence greatly the future role and contribution of the agricultural sector.

It is essential that the development of the 1985 farm bill be premised upon a clear understanding of the structure of today's agriculture and its relationship to the Federal Government. Contemporary production agriculture presents important policy implications perhaps requiring a fundamental redefinition of the farm problem and thereby a change in its solution.

At the center of the current farm policy controversy is the magnitude of government payment assistance to agriculture. An understanding of the distribution of this assistance by type and size of farm has important policy implications. According to the Department of Agriculture, $4.1 billion of direct government payments (excluding payment-in-kind) was distributed to 2.4 million farms in 1983 (Table VIII.5). However, $3.2 billion, or almost 80 percent of total government payments, went to 599,000 cash grain and cotton farms constituting just 25 percent of all farms.

TABLE VIII.5.—DISTRIBUTION OF GOVERNMENT PAYMENTS BY NUMBER AND TYPE OF FARM

	Total all farms	Total L'stock farms	Total crop farms	Cash grain farms	Cotton	Other farms [1]
Number	2,370,000	1,238,000	1,087,000	568,000	31,000	488,000
Percent of all farms	100.0	54.1	45.9	24.0	1.3	20.6
Direct Government payments ($ millions)	$4,053	$577	$3,476	$2,638	$577	$281
Percent of total Government payments	100.0	14.2	85.8	65.1	13.7	6.9
Average payment per farm	$1,710	$450	$3,198	$4,644	$17,968	$576

[1] Tobacco (136,000); other field crops (132,000); vegetables and melons (34,000); fruit and tree nut (86,000); horticulture specialty (31,000); general crop (69,000).

Source: U.S. Department of Agriculture.

Data describing the distribution of government payments by number, type, and size of farm are not available. However, it is known that 22 percent of government payments in 1983 went to farms with annual product sales of greater then $200,000; 56 percent to farms with annual sales of $40,000 to $20,000; and the remainder, 22 percent, to farms with annual sales of less than $40,000. Also, 24,000 farms had product sales greater than $500,000 and showed an average combined net farm income and off-farm income of $569,383 (Table VIII.6). The income of these largest farms was supplemented with an average direct government payment of $26,188.

In 1983, over $2 billion of government payments went to 107,000 farms with annual sales of $200,000, or more, and average incomes of $174,289. Over 44 percent of total government payments in 1983 went to farms with average total farm incomes (net farm income plus off-farm income) in excess of $26,000. On average, these farms received a government payment income supplement of $14,552 in 1983. It also should be noted that, even after including off-farm income, government payments constituted 37 percent of gross farm income for those 381,000 farms with annual sales of $40,000 to $99,999 and 31 percent of gross farm income for those 177,000 farms with sales of $100,000 to $199,999 per year, indicating a high degree of dependency of these average-sized farms on government payments.

TABLE VIII.6—DISTRIBUTION OF NET FARM INCOME, OFF-FARM INCOME, AND GOVERNMENT PAYMENTS (INCLUDING PAYMENT-IN-KIND) BY VALUE OF SALES CLASS, AVERAGE PER FARM,1983

	$500,000 and over	$200,000 to $499,999	$100,000 to $199,999	$40,000 to $99,999	$20,000 to $39,999	Less than $20,000	All farms
Farms (000)	24	83	177	381	272	1,433	2,370
Net farm income [1]	$540,780	$45,435	$14,844	$2,511	—$681	—$1,115	$9,260
Off-farm income	$28,603	$14,610	$11,793	$11,253	$13,764	$20,265	$17,299
Total	$569,383	$60,045	$26,637	$13,764	$12,866	$19,150	$26,599
Government payments	$26,805	$16,798	$11,837	$8,143	$3,626	$749	$3,922
Total	$596,188	$76,843	$38,474	$21,907	$16,492	$19,899	$30,481

[1] Excludes government payments.

Source: U.S. Department of Agriculture.

It may be concluded from this analysis that the great bulk of direct government financial assistance—almost 80 percent—goes to a relatively small portion of agriculture—599,000 farms or 25 percent of all farms. Among these 599,000 may be several thousand farms which, because of their large value of sales and/or substantial off-farm income, may neither need nor deserve public financial aid.

This distribution of government payments, of course, is the consequence of attempting to control the supply of grain and cotton. To effectively limit supply, large farms must be enticed to participate in supply control programs by large government payments; the level of farm income is immaterial.

Farm wealth or proprietor's equity is also immaterial in the allocation of public assistance to agriculture. The average farm with sales in excess of $500,000 received a government payment of $26,805 in 1983, and reflected a proprietor's equity of $2.7 million. As is the case with farm income, the larger the wealth or net worth of a farm, the larger the government payment.

The consequence of traditional farm programs, notwithstanding the "farm problem," as popularly and accurately perceived, is low farm income and declining farm equity. Clearly, the "solution" does not fit the problem.

But then what is the solution and, if there is a solution, can we begin its implementation through the 1985 farm bill?

The solution, like the problem, may be found in the diversity of farming itself. The size of farm operations strongly influences farm program needs. As reported earlier, farms with annual gross sales in excess of $200,000 show average incomes, including income from off-farm sources, of $174,000 per farm. Farms with incomes in this range should hardly be eligible for taxpayer-supported income enhancement programs. However, large farms, which have substantial capital investments and debt loads, are usually very dependent on exports sales and, therefore, are very vulnerable to unstable and erratic income levels. Large farms participating in supply control programs compromise the productivity and efficiency of their farm units, thus, increasing their average per unit cost of production. Besides, 70 percent of our food supply originates on these farms. Farm programs for larger farms should emphasize methods by which these farmers could insure some degree of income stability.

Several witnesses before Joint Economic Committee hearings, as well as studies performed by a Department of Agriculture task force and the Congressional Budget Office (CBO), examined the role that farm revenue or income protection insurance could play in stabilizing farm income. According to the CBO study, revenue insurance, provided by the Federal Government, would guarantee a farmer that revenue per acre of each crop would not fall below some proportion of expected revenues. For example, a corn farmer might insure 75 percent of average revenues per acre based upon recent experience. If revenue from the corn crop was less than the insured level—due to either low yields or low prices—the farmer would receive an indemnity equal to the difference. There would be no indemnity if revenue levels were inside the normal range of variation.

In this manner, revenue insurance, it is contended, would protect farmers against precipitous declines in gross income regardless of whether price or production variability was the cause. In exchange for this protection, farmers would pay an annual premium that reflected their individual risks. This would minimize the possibility that farm revenue insurance would encourage inefficient farming. To encourage participation, the Government could subsidize premiums. Revenue insurance, perhaps with partially subsidized premiums where the rate of subsidization declines as the desired level of income to be insured increases up to, say, a $200,000 miximum, may be worthy of consideration.

Large farms are generally productivity, expansion and growth-oriented. These highly efficient farms need and deserve free and fair access to world markets. Growth means expanding exports and assurance that the United States will secure and maintain a reputation as being a reliable supplier. These farms are the most efficient food producers in the world and this comparative advantage needs to be supported by export loan guarantees, aggressive pursuit of multilateral, bilateral, and bartering agreements, and the promotion of export sales of value-added products.

Small farms with substantial off-farm income reap more benefits from tax policy than either farm policy or product sales. As a general rule, farms with annual sales of less than $20,000 always have, and likely always will, lose money providing and adding to price-depressing surpluses of agricultural commodities. These farm losses are often used to shelter off-farm income. A recent study by the Internal Revenue Service identified 12,000 farms with farm losses exceeding $50,000 a year. The average off-farm income of these "farmers" was $122,000. After deducting farm losses, these individuals paid taxes on an average adjusted gross income of less than $17,000. Perhaps farms which consistently show losses should not be eligible for government payments. Or, to the extent farms receive government farm aid, such aid should be reduced dollar for dollar if farm-loss sheltering exceeds, say, $21,000, the national average level of household income. In any event, farm programs should not encourage the production of farm commodities for the ultimate purpose of incurring losses and sheltering nonfarm income.

Our public farm policy priority and focus belongs to the medium-size and the many small farms which are heavily dependent upon farm earnings and, therefore, deserving and in need of access to farm programs which would provide both income enhancement and stability. To enhance income, perhaps consideration should be given to the provision of a combination of payments for storage services and the performace of approved conservation practices.

An indirect, income-enhancement program might involve providing farmers—through their bankers—direct access to low government cost-of-money interest rates in return for idling land for the duration of the life of the loan. For example, a seven-year loan, 5 percentage points lower than commercial rates, might carry with it a requirement to idle, say, 10 percent of the farmer's land for the next seven years.

For income stability, an income or revenue insurance program as described above for large farms might be equally appropriate for medium and small farms. As the level of income to be insured would likely be considerably less, the government subsidization rate could be higher than that offered to large farms. For example, the government could pay 100 percent of the premium for the first $25,000 of insurance, 95 percent for the next $25,000, 85 percent for the next $50,000, 65 percent for the next $50,000, and 35 percent for the next $50,000.

Revenue insurance also could be used to supplement more traditional price-support/supply control programs. That is, farmers could be provided the opportunity to purchase incremental price protection insurance over and above some established target price. For example, assuming a target price of $3.00 per bushel for corn, a farmer could purchase an additional 25 cents per bushel of price protection to effectively insure a price of $3.25 per bushel.

As an alternative means to stabilize income and ensure revenue, consideration may also be given to the Government subsidization of the payment or premium associated with farmer purchases of options in futures markets. In an option contract, the farmer secures the right—but not the obligation—to sell a specified quantity and quality of a commodity at a specified price in exchange for a present premium.

This purchase of a right to sell a certain quantity of product at an established price provides insurance against major price and, therefore, income movements. The Government might, for example, provide up to $20,000 per farm for the purpose of subsidizing the purchase of options. Assuming the premium is 10 percent of the ensured price and the ensured price is $3.00 per bushel of corn, a $20,000 premium subsidy would pay the full cost of the purchase of the right to sell about 66,700 bushels of corn ($20,000 divided by 30 cents) and thereby ensure an income of $200,000 (66,700 bushels times $3.00 per bushel). A $10,000 subsidy per farm could be used to pay one-half of the premium costs associated with ensuring a $200,000 revenue.

Another farm program concept often talked about concerns variable target prices. There are basically two versions of this proposed program. The first would involve the establishment of a relatively high target price which would be applicable to a certain percentage or volume of a farmer's production. Target prices for production beyond this level of output would be lower or perhaps even unavailable. The second version ties the level of target prices to supply control. That is, farmers would be eligible for a higher target price the more land they set aside to control production. While these programs would be extremely difficult to equitably design and administer, their unique features deserve further analysis.

There are other ways to protect farmers against volatile incomes. One example is Canada's Western Grain Stabilization Program (WGSP). Its objective is to stabilize farmer's annual cash flow—the difference between cash receipts and cash production expenses. A farmer may join the program and drop out during the first three years of his enrollment; after three years, he must stay in the program. Farmers pay a portion of their proceeds from annual grain sales into a stabilization fund and there is a maximum yearly contribution. The Canadian Government's annual contribution is twice the farmer's contribution. At the end of each year, industry cash receipts, production costs, and the net cash flow are estimated. If the estimated cash flow is below the average for the previous five years, a payment is made to participating producers. The total payment is the difference between the current cash flow and the five-year average, the payment to each producer being proportional to participation.

Revenue, price or option insurance, storage and conservation payments, the offering of lower interest rates to encourage supply control, variable target prices, and the applicability of the Canadian income stabilization program to U.S. farming all possess characteristics which could result in better targeting of program benefits and more responsiveness to market signals. The result of that combination is reduced government outlays and increased efficiency.

These programs are barely more than concepts at this point in time. Program details and farmer and government costs are yet to be determined. However, debate over these concepts should not cloud their intended objective—to design and implement targeted farm programs which will at long last yield sufficient income enhancement assistance where it is needed the most while simultaneously unleasing and supporting our most productive farms to capture world markets.

CONCLUSION

There is little question at this time that government payments to agriculture will be reduced in the years ahead. Providing fewer resources to the same ineffective programs will dramatically alter the structure of American agriculture, because it will not be the very large or the very small farms that will be forced out of business, but rather the economically most vulnerable of our farms, the full-time, average-size family farm.

The trend, as recently confirmed by the 1982 farm census, strongly indicates the eventual loss of the average-size family farm. This trend suggests that by the year 2000, as few as 50,000 farms may be producing two-thirds of this country's agricultural output. It is evident that the continuation of traditional farm programs will result in an agricultural sector composed of the two organizational extremes of agri-factories and small suburban hobby farms. The 1985 farm bill will either confirm or deny this destiny.

In addition to farm programs being tailored to meet the economic needs and requirements of today's structurally diverse and internationally oriented agriculture, these programs must be sensitive to potential impacts on all agriculture, especially non-program commodities, livestock, agribusiness, and rural communities. American agriculture is a highly interdependent social as well as economic system.

And just as agriculture is grappling with significant economic change, all of rural America too must face up to the challenges of the 1980's. Not only are rural areas adjusting to changing local economic structures but to a changing relationship with the United States and world economies as well. Consequently, a host of rural issues must be raised. Among them are the following: (1) the economic prospects of rural communities and small business; (2) the rural economy's labor conditions, resource bases, industrial bases, and investment and finance requirements; (3) the adequacy of transportation, energy, water, communications, education and health care systems, and other infrastructure needs; (4) the role of technology in rural development; (5) the condition of State and local governments in light of fiscal limitations, decreasing Federal assistance, and federalism; and (6) public policy toward rural areas in the context of changing rural and urban environments.

Chapter IX. THE REVIVAL OF ENTREPRENEURSHIP

Today's economy is undergoing a transformation that is as revolutionary in its implications for the future as the industrial revolution of the 19th and early 20th centuries had been for previously agriculture-based economies. Like earlier economic revolutions, this one is changing the ways in which business firms operate, and changing the nature of business itself. The revolution has begun with a bang, is likely to spawn new revolutions in its course, and—most important—has changed the ways in which people will assess the future of the country.

Analysts have alluded to the transformation of the United States and other post-industrial economies as a shift from industrial-based to service-based production. An important aspect of this shift has been that traditional manufacturing industries were expected to decline as newer, service-oriented firms took over a larger proportion of the gross national product.

The new industrial revolution is based on high technology development. This development is resulting in new products, processes, and services in such diverse areas as information technology, computers, telecommunications, and biotechnology, to name but a few. Importantly, and in addition to the new industries created by high technology, the goods and services produced can be applied to traditional manufacturing to improve productivity, efficiency, and the competitive position at home and abroad of many of our traditional industries. For example, the apparel industry is in the process of developing advanced technologies that could automate clothing manufacture. The footwear industry—long considered a labor-intensive, low technology business—has developed a research agenda that could propel footwear manufacture into the realm of "high tech." And General Motors recently announced that it was developing an automated means of passenger car manufacture that may well revolutionize the way American auto firms do business.

Changes in the economy brought about by the technological revolution pose new challenges for government policy. These changes have spotlighted technology development as an important contributor to the strength of the United States, economically, militarily, and socially. They have also focused attention on entrepreneurship—the act of seeking innovative approaches to solving problems, taking risks, and creating new economic opportunities—as a means to ensure that an innovative idea becomes a commercially viable and available product or process which can contribute to our collective economic growth.

The interest in entrepreneurship reflects several developments in the national and international economies which serve to underscore the importance of the entrepreneurial endeavor.

First, the shift of the U.S. economy from a primarily goods-producing to a more information-oriented base, and the geographic shift of business activity from former centers of commerce in the industrial north toward the "sunbelt" States, focus attention on the role of business formation in economic development. The more rapid this structural change in the economy, the more prominent the role. In recent years, the mobility of the population has contributed to a surge in business incorporations, especially in formerly less developed parts of the country. Business formation reached a level of 600,400 new companies in 1983, up from 478,000 in 1978. The employment effects of this growth are also impressive: Approximately 80 percent of the 10 million new jobs created over the past decade has been in new businesses and the expansion of existing small firms.

Second, some far-reaching technological breakthroughs have prompted the formation of lines of business that did not exist only a few decades ago. Over the past 30 years, this explosion of technology has created a dramatic increase in the amount of scientific knowledge, much of which has had commercial potential. The invention and commercialization of integrated circuits, advanced materials, biotechnology products, and flexible manufacturing systems have given rise to a set of industries whose technologies promise significant advances in productivity and product design.

Third, several highly publicized cases have focused public attention on the role of the entrepreneur in the economy and on the rewards that attend successful entrepreneurial efforts. The Silicon Valley area of California and the Route 128 perimeter around Boston, Massachusetts, are looked upon throughout the world as models for high technology entrepreneurial development. Often with these examples in mind, many States and local governments have established high technology initiatives, such as research parks and cooperative research centers, to bring the economic rewards of high technology growth within their borders. A recent study by the National Governor's Conference indicates that every State has embarked on some kind of high technology development initiatives as a component of their overall economic development strategy.

Fourth, the pressures of international competition, and the wider opening of the world economy to trade among nations, has prompted a closer look at the characteristics that enable U.S. trading partners to compete with U.S. firms on U.S. soil. What that look has often shown is that the application of advanced manufacturing technologies in countries such as Japan is more widespread than it is in this country. This, in turn, has resulted in renewed emphasis on the ability of U.S. entrepreneurs to manage technological change within their industries.

These developments have prompted the Joint Economic Committee to devote considerable effort to examine the Federal policy implications of entrepreneurial activity, under the leadership of Representative Daniel E. Lungren. In a wide-ranging series of hearings during 1983 and 1984, both in Washington and in the field, the Committee heard from government officials at all levels, successful entrepreneurs, university officials, and leading economists. Three studies of the Committee during the past two years have examined the factors that influence business location, the issues raised by venture capital activity, and the subject of entrepreneurship itself.

This chapter draws upon these hearings and studies and summarizes the Committee's findings under the headings of (1) Issues in Technology Transfer, (2) Issues in New Business Development, and (3) Federal Entrepreneur Initiatives. A section at the end of this chapter sets forth recommendations for Federal action in support of new, technology-intensive firms. A more comprehensive discussion of entrepreneurship and innovation, based upon much of the information obtained in the hearings held in Washington, Silicon Valley, and Route 128 near Boston, will be released in a forthcoming Joint Economic Committee study.

ISSUES IN TECHNOLOGY TRANSFER

The Federal Government currently spends nearly $50 billion annually in research and development which includes a diversity of enterprises spanning from defense to agricultural and energy projects. The extensive store of expertise and technology that is developed from these federally funded research and development pursuits frequently has potential application beyond the objectives of the specific mission requirements of each project. Because of this possible "spin-off" application, the developed technologies and expertise can have significant beneficial impact on the economic growth of many of our domestic industries, their ability to compete internationally, and upon the quality of the American life.

This process—where technology developed in one organization, in one area, or for one purpose is applied and utilized in another organization, in another area, or for another purpose—is called technology transfer. The aim of technology transfer is to implement new technical and managerial knowledge, leading to improved production methods and processes, and to new products and services. The benefits from technology transfer include more efficient utilization of resources, increased productivity growth, and a more competitive economy. To name just one example, freeze dried foods were developed from the work of the National Aeronautics and Space Administration.

Regrettably, this vast technological resource has been largely untapped in the United States. In fact, companies in other countries—as well as the government of the Soviet Union—have proven more proficient at utilizing these developed American resources than have the companies and entrepreneurs in the United States. Often their American counterparts are unfamiliar with the technology developed in one environment and the process and rewards of transferring it into the commercial market. An additional hurdle results from the fact that technology transfer typically best occurs on an ad hoc and individualized basis where the application can best be tailored to the specific needs. While there is an important governmental interest in the transfer of technology to other processes and organizations, its primary development must occur through the private sector. However, to facilitate this commercialization process, the Federal Government can serve several leadership functions, as described below.

The Federal Interest

Initially, the Federal interest results from the need for certain goods and services, which are obtained from research and development, in order to function. Down the line, after the mission requirements of the agency have been met, the governmental interest extends to the promotion of the transfer of technology to other levels in government—Federal, State, and local—and to the private sector, since there are significant rewards which can be reaped through the development of commercially viable products and processes. In recognizing this need, several important actions have been taken.

In 1974, the Federal Laboratory Consortium (FLC) was established to help promote and intergrate the transfer for technology to Federal and State governments and with the private sector. The FLC consists of almost 300 Federal laboratories who participate on a voluntary basis. The consortium has played an important role in providing technology and technical know-how to address government problems for the purposes of commercialization in the private sector. However, as the recommendations at the end of this chapter suggest, more avenues can and should be actively pursued with the direction coming from the Federal Government.

The Stevenson-Wydler Technology Innovation Act (P.L. 96-480) took an important step toward statutorily acknowledging the Federal role in promoting technology transfer. This law stipulated a government responsibility to assist in the application of technology to other ends by mandating the transfer of this technology and expertise where appropriate by allocating a minimal portion of each Federal department's research and development budget toward this end. Since the Stevenson-Wydler Act must be reauthorized during the 99th Congress, there will be an important opportunity for the Congress to assess the proper—and perhaps develop a more effective—manner of assisting the process of technology transfer. Finally, the constitutional authority given to the Congress to oversee the patent process provides a continuing responsibility to ensure that innovation is promoted and rewarded.

Industry-University Relations

A major source of basic research in this country is the Nation's excellent public and private university system. For this reason, large commercial firms regularly maintain contact with science and engineering departments at several universities. A leading industrial firm may have informal contracts with several dozen university professors, and belong to 10 or more "industrial associates" programs at different universities, while also engaging in several one-to-one research contracts with such departments and/or university research consortia. Another important motive for maintaining university ties is also the opportunity to gain access to promising students prior to graduation. The recently graduated student who has been working on a promising line of basic research is an effective vehicle for technology transfer.

Observers of industry-university interactions cite the traditional roles of these institutions as the prime barriers to more effective cooperation. The basic research engaged in by universities in an atmosphere of academic freedom and with a tradition of publishing research results, often clashes with industrial needs for commercially viable research and corporate secrecy. Nevertheless, studies have shown that these traditional barriers can be overcome by creative structuring of agreements that give universities publication rights and firms the development rights to new research findings.

There are, however, other factors which at the present time impede a more effective working relationship. At a time when research is becoming increasingly expensive, because of the costs of purchasing and maintaining expensive, advanced technology equipment, universities often do not have the capabilities of many large commercial firms for performing even basic research. In fields such as ceramics and electronics, where new technology is rapidly developing, many universities must play "catch-up" with industrial firms in order to perform effective research and even instruction. In the area of manpower, salary differentials between industry and academe work to the disadvantage of universities. There is a greater financial incentive for a bachelor of science or engineering degree holder to obtain employment immediately rather than pursue graduate studies. As a result, the number of Americans in science and engineering graduate training has declined since the mid-1970's.

Considerable publicity has been given recently to industry-university cooperative projects in such fields as chemistry, ceramics, robotics, and polymer research. Many universities have become more active in soliciting corporate funding for capital projects and for research. Within State university systems, especially, industry-university cooperative projects have mushroomed within the last five years. Many, although not the majority, of such projects are aimed at smaller firms.

One lesson being learned is that such efforts can be successful, in terms of the amount of business interest being generated, but must be carefully planned according to the circumstances of each project. This kind of planning is most effective when considerable leeway is given to the persons who are most actively engaged in the administration of the project (e.g., university department head, corporate research director). Another element that is common to successful efforts is the presence of strong, dedicated leadership at the university and corporate levels. Again, this underscores the prominent role of the individual in fostering effective and rapid technology transfer.

The record of university-sponsored centers for assisting new, entrepreneurial facilities is still too young for a valid assessment of its national impact. It should be noted, however, that many such centers have been financed either without Federal funds or with noncategorical funding such as Urban Development Action Grant (UDAG) or Community Development Block Grant (CDBG) outlays. Many of these centers have often been established as a function of State or local economic development initiatives. Still others reflect industry-university cooperation without any government involvement. Successful centers will undoubtedly serve the economic development function adequately, inasmuch as they will become a focus for a large volume of commercially useful technology.

Tax Considerations Regarding Technology Transfer

Several provisions of the Tax Code serve as incentives either to engage in R&D, acquire new capital equipment, or invest in venture firms. These include the R&D tax credit, the investment tax credit, and the accelerated cost recovery system of depreciation allowances.

Proposals to change or eliminate some of these features will probably figure in the coming congressional debate over tax simplification. The R&D tax credit, for example, does not, at present, apply to the creation of computer software, although R&D outlays in this area are considerable. With regard to ACRS, studies have shown that business capital formation has been accelerated, but some critics charge that, by providing for accelerated depreciation of all equipment, ACRS favors the heavy manufacturer over the high technology firm and service company.

During its appraisal, the Joint Economic Committee found no specific instance where the development of a particular technology either was significantly accelerated or deferred solely on the basis of tax considerations, although tax policy was found to be important. The truth is that the ACRS and the R&D tax credit have been in place for too short a time for one to make a definite assessment of their total effect. It needs to be noted, however, that the tax credit device is not available to a firm, such as a startup firm, that has no tax liabilities and, as such, can be of only limited usefulness for new, entrepreneurial ventures.

A large number of other legislative, regulatory, and policy issues affect the efficiency or rapidity of technology transfer. Some of the more important of these are described below:

- The Reagan Administration's initiative in promoting the concept of R&D limited partnerships, and in sponsoring legislation to that end, has undoubtedly had an effect in the formation of several major ventures, and has removed the antitrust inhibitions clouding joint research ventures.
- Federal procurement regulations and practices work at times against the more effective transfer of technology. At least three areas deserve special mention:
    1. Contract specifications for projects taking place over a long period of time can "freeze" a project into the known technology as of the time the specifications were published. Actual bidding on contracts could start a year or more afterwards, at which time preferable technology may have been developed, but cannot be utilized.
    2. The tradition of cost-plus contracts, coupled with renegotiation procedures, leave little incentive for a firm to adopt new, cost-saving technology in the carrying out of a large, Federal procurement contract.
    3. Some procurement develops inventions that are so "project-specific" as to dilute the usefulness of the new technology outside the project for which it was designed. In some of these cases, careful attention to the technology transfer aspects of the project could have avoided such a result.

- Observers of the Nation's scientific and technological infrastructure warn of serious shortcomings in the way scientific subjects are taught in secondary schools, and in the lack of incentives for science and engineering students to continue their studies into graduate school. These issues have important implications for the ability of future generations to continue at the forefront of technology development. There is a need to continue to place a high national priority on the improvement of scientific/technological literacy in American schools.

ISSUES IN NEW BUSINESS FORMATION

The United States has traditionally upheld the principle that small business is the backbone of the Nation's commercial system. Following this tradition, the Congress has pursued a policy of promoting competitive markets so that small business activity can flourish. In this connection, our antitrust laws, which are designed to enhance competition, are important to this goal. Also, Congress has enacted laws providing for loans, loan guarantees, and technical assistance to small businesses. Federal procurement regulations require set-asides for small business; other Federal programs identify minority-owned small businesses as eligible for certain advantages. These policies are currently under review.

Policies to aid small business per se, however, are not the same as policies to promote entrepreneurship. Until recently, the Small Business Administration's statutory responsibilities have not emphasized the facilitation of more rapid technology transfer, of the promotion of technology-intensive firms, nor has Federal policy fully recognized the importance of entrepreneurship (or intrapreneurship) in large organizations.

Small Business Innovation Research (SBIR)

In 1982, Congress enacted the Small Business Innovation Development Act, with the goal of increasing the amount of government R&D being performed by smaller firms. The model for the Act had been a National Science Foundation (NSF) program which, since 1977, has made annual research solicitations aimed exclusively at small business. Firms receiving awards were eligible for follow-on grants, wherein one requirement was the commitment of matching funds from a private source (e.g., venture capital group, larger company).

Firms participating in the NSF program have made advances in such diverse fields as cellular biology, surface acoustic wave technology, crystal manufacture, and automated welding. The origins of, and personnel within, these companies have also varied, from professors who have started high technology firms, to engineers from large companies forming a small company on their own.

The present program, which is governmentwide, is overseen by the Small Business Administration (SBA), but administered through each agency. A set-aside of 1.25 percent of each agency's R&D budget is to go to small firms. While it is still too early to assess its progress, the response to solicitation announcements indicates that many small firms believe they are in a position to perform leading edge research that is close to commercialization.

Incubator Facilities

"Incubator" facilities for small advanced technology business have been established in many State and local governments in recent years, as a response to the perceived potential for employment and economic development that can be generated by these firms. Such facilities normally provide technical and managerial assistance, low rents, and common support services; in some instances, the incubator center houses professional support establishments such as law firms, accounting firms, and venture capital services.

The legal and organizational framework of these centers vary. Some have been established by private developers, both with and without provisions for equity participation in the tenant firms. In most cases, State and/or local governments are sponsors, and many such centers have some affiliation with a local university. Federal laboratories also provide assistance at some centers.

Incubator facilities operate under the theory that insufficient services exist for new, small firms whose commercial potential rests on relatively unproven technology. Although approximately 100 such centers exist today, they are mostly of recent origin and have not developed a sufficient record to assess their effectiveness.

As a result of an Agency reorganization in 1982, the SBA now administers a clearinghouse aimed at promoting the establishment of such facilities.

Tax Considerations Regarding New Business Development

There are a number of Federal policies that affect new business development. Also, some State and local governments have utilized tax incentives, such as tax moratoria, in order to encourage expansion of new firms inside their jurisdiction.

Federal tax treatment of stock options may, in fact, serve as a disincentive to new business development. Its complexity, and its built-in ceilings, discourage some firms from instituting stock-option plans. The requirements it places on the timing of the tax sometimes forces taxpayers to sell their holdings immediately in order to pay their taxes, thus vitiating the purpose of the plan of rewarding longer term loyalty to the company. This tax disincentive is considered to be especially onerous with regard to new, high-risk, technology-intensive firms, for whom the stock option is one of the few effective ways of attracting and keeping quality employees.

The tax treatment of capital gains is intended to encourage investment in corporate equity. Testimony before the Joint Economic Committee revealed that the differential in the treatment of capital gains vis-a-vis ordinary income tax rates results in a greater incentive for investment in venture capital than the level of the tax rate itself. Some tax proposals would reduce this differential, while keeping the rates themselves below the levels that existed prior to 1982. This differential is as important in attracting trained and expert personnel as it is in promoting investment (i.e., it takes a good differential to attract a person away from a secure position—taxed at regular income tax rates and under personal tax provisions—to a risky position, but with promise of good capital gains).

Federal Entrepreneurial Initiatives

The foregoing discussion highlights the importance of technological development to the national welfare. Many factors play roles in technology development. One of the most important is the entrepreneur, the person who takes an idea and makes it a marketable good or service, product or process. Technology transfer—the application of technology developed in one organization, one area, or for one purpose is applied and utilized in another organization, in another area, or for another purpose—is one way an entrepreneur can provide opportunities for increased innovation. The knowledge derived in the research and development process, if applied, commercially, is one of the prime drivers of growth in the national economy.

Interest has focused on the entrepreneur and on small companies as a critical factor in technology development. Several principles seem to apply:

1. There is no correlation between the origins of such firms and their chances for success. Examples of successful high tech firms include those that have been established by individuals and by large corporations, that have been financed by government or exclusively by the private sector, that have been purchased by the major financial backer, and that have not sold any equity to the major backer.
2. The most critical variable in the success or failure of a new venture is the personality and abilities of the entrepreneur him/herself.
3. Although small businesses provide most of the increases in employment in this country, and a major share of commercialized high technology, this country lacks an established policy for promoting advanced technology among small firms.

In answers to questions aimed at identifying the success of a particular research contract, firm, or area such as Silicon Valley, Joint Economic Committee witnesses and interviewees gave particular weight to personalities and individual achievement. This finding suggests that a valid goal for Federal policy should be to create an optimum environment for a more rapid and effective transfer of technology from the research stage to the "entrepreneurial" one, rather than attempt to subsidize or regulate entrepreneurial activity itself.

Nevertheless, certain problem areas, on the one hand, or opportunities for improvement, on the other, come to the surface on a close examination of Federal Government activities for entrepreneurship:

1. *The guiding principle for Federal entrepreneurial initiatives should be to create an environment that rewards risk taking without substituting the Federal Government's judgement for that of the entrepreneur.*—The entrepreneurial system thrives when the rewards for successful risk taking are high. However, the form of business organization, and the mode of research, have been shown to vary so highly as to preclude any

conclusions about what constitutes the best form of entrepreneurial organization.

2. *An important element of promoting entrepreneurship is the adoption of policies that establish and maintain balanced noninflationary growth in the economy, and that achieve relatively low real interest rates.*—Risk taking suffers during times of severe economic uncertainty. High interest rates also raise significantly the barriers to venture capital. The adoption of successful marcoeconomic policies could possibly constitute the most effective single spur to increased entrepreneurial activity.

3. *The Federal Government should continue its support of basic research, which is the lifeblood of technology-based entrepreneurship.*—The Reagan Administration has maintained significant increases in Federal R&D spending, notwithstanding the need to gain control over budget outlays. Such spending is a necessary investment in America's future.

4. *The Federal Government should develop an entrepreneurial climate which includes policies that remove barriers to small business expansion and technological innovation from advances in science and technology.*—The Reagan Administration has already placed many of the elements of such an effort into effect (e.g., lower capital gains rates, R&D limited partnerships, and SBIR legislation). Additional improvements could come in such fields as procurement, and the operation of Federal laboratories.

5. *Federal funds used for entrepreneurial activity, such as incubator facilities, should remain extremely flexible, so as to conform to the variety of entrepreneurial activities and the needs of State and local governments.*

6. *Federal entrepreneurial initiatives should examine closely the Government's procurement system to identify rigidities and other practices that inhibit entrepreneurial development and technology transfer. The same effort should also identify opportunities to adopt the increased use of advanced technologies in procurement.*—Federal procurement is one of the most effective means for the government to encourage the commercialization and implementation of new technologies. However, its rigidities often prevent this from happening. Enough examples exist of enlightened procurement practices as to improve the system significantly if these practices were adopted government-wide.

7. *Changes in the Tax Code should be considered in the context of the resultant entrepreneur's environment for risk taking.*—Congress should give consideration to removing the complexities and inhibitions in the treatment of stock options. In addition, means should be developed for new firms to utilize such incentives and the R&D tax credit, and to extend the credit itself to software R&D. If changes are to be made in the tax treatment of capital gains and depreciation, these changes should maintain the incentives for venture capital development that are built into these provisions and, in particular, maintain the differential between the treatment of capital gains and ordinary income.

8. *The Federal Government should improve technology transfer from Federal laboratories.*—This suggests that additional ef-

forts could be made in such areas as industrial work assignments or exchanges for Federal personnel, and incentives for continuing education of Federal scientists and engineers. It requires that special attention be paid to the scientific and technological literacy of this country. It also suggests that policies be flexible enough to accommodate different situations, technologies, and people.

The Congress should consider mandating a national conference to introduce and link representatives of Federal Government, university, local and State government, large and small industry, and their various common-interest associations. Such a conference would be the opening step in a continuing dialogue and meeting among these groups, focused primarily on forging new cooperative efforts. It could also function as an umbrella consortium of organizations that could provide a vital clearinghouse function on "who's doing what" in cooperation and transfer.

This would help address a frequently heard comment from potential users of Federal technology that they were unaware that Federal laboratories had expertise or technology useful to them and certainly had no idea that practical technology transfer was available to them.

Congress should consider encouraging each agency and laboratory to examine its policies, rules, and procedures with respect to facilities access, equipment loan, technical assistance, and other methods of cooperation; and to shift their emphasis to stress technology transfer results over restrictions.

An additional consideration for the Congress is to have each laboratory or center with an annual in-house expenditure greater than $200 million required to assign at least one full-time professional to technology transfer; agencies with much smaller research facilities could dedicate staff on a regional or national basis.

To encourage an entrepreneurial spirit in technology transfer within each laboratory, Congress may consider coupling the mandate for effective technology transfer with an approval process that audits the propriety of past activities rather than to require detailed prior bureaucratic approval of all unusual and even some routine transfers.

Technical staff on each program, involved in devoting some time to active technology transfer (depending on the nature of the technology), will foster this process, particularly if the laboratory or agency requires a report on transfer activities as part of program reporting. Congressional encouragement that agencies provide identified technology transfer funds in each program and laboratory would significantly strengthen the support for this activity by the technical staff and first-line managers.

The Silicon Valley and Route 128 areas are often held out as examples of how this country should proceed in promoting entrepreneurial development. As this chapter indicates, many State and local governments are attempting to do just that within their own borders. It should be noted, however, that these two major success stories took place without the benefit of large Federal programs specifically directed at entrepreneurial activities.

There is much that the Federal Government can do in creating the right environment for creative entrepreneurial activity. The essence of entrepreneurialism, however, dictates that the Federal Government keep its distance regarding the details of new venture business formation. If properly pursued, Federal policies to promote a vibrant entrepreneurial climate can guide the United States through the transition to an information economy. And it can create the conditions for a new wave of industrialization based on advanced technologies in manufacturing.

Chapter X. PRIVATIZATION IN THE FEDERAL GOVERNMENT

Although, from time to time, government has disposed of publicly held assets, the concept of privatization—the transfer of public assets, infrastructure, and services to the private sector—has recently been recognized as a new area of public finance. It is so new that the word, "privatize" was entered in Webster's New Collegiate Dictionary for the first time in 1983.

During the course of several hearings before the Joint Economic Committee, a wide variety of privatization advantages were documented. Most of these ultimately centered on the fact that property rights arrangements are not neutral. If property rights are altered, the incentives that face individuals are altered, and so is their behavior. In consequence, the performance of organizations depends on the property rights arrangements that govern various organizational forms. For example, private organizations supply the same quantity and quality of goods and services by using far fewer resources than do publicly owned organizations. To put it another way, private organizations can produce the same goods and services at lower costs.

The cost advantages associated with private organizations have important implications for the Federal Government and the provision of goods and services now supplied by the Federal Government.

COMPARATIVE COSTS—PRIVATE VERSUS PUBLIC ACTIVITIES

To gain an appreciation for the cost advantages associated with private, rather than public, ownership, some examples are presented. To begin with, a perspective on private versus public performance can be gained by reflecting on Europe's nationalized industries.

Europe's Nationalized Industries

Europe's nationalized industries provide a comparison of private and public enterprise performance. Public enterprises in Europe produce everything from pots and pans to cars and trucks. They even run hotel chains. In doing so, these public enterprises are quite different from their private counterparts. The most striking feature of nationalized enterprises is their politicization. Governments appoint the boards and top management. Governments provide subsidies, since most nationalized companies lose money. Politicians must be consulted and approve major decisions. Government, therefore, determines pricing, purchasing, plant location and closedown, diversification, incentive systems, executive compensation, product development, and financial policies. Labor relations are also regulated by politicians, and they are much more stormy in nationalized industries than in private companies. Not surprisingly, successful managers of nationalized enterprises resemble politicians rather than businessmen.

The public ownership of nationalized enterprises and their accompanying politicization leads to an interesting set of comparisons between nationalized concerns and similar private concerns. Sales per employee are lower for nationalized firms. Adjusted profits per employee are lower. Per dollar of sales, operating expenses plus wages are higher. Sales per dollar investment are lower. Profits per dollar of total assets are lower. Profits per dollar of sales are lower. Sales per employee grow at a slower rate. And, with the exception of nationalized oil companies, virtually all nationalized companies generate accounting losses.

Evidence from Europe's public enterprises is consistent with the notion that property rights arrangements are not neutral, and that private enterprises are more efficient than public enterprises. Now comparative cost evidence of a more specific nature is presented.

Administrative Functions

Debt Collection.—Debt owed to the Federal Government is considerable, about $220 billion, and a considerable amount of this is represented by uncollectable accounts. Moreover, the volume of these bad debts has been increasing. Part of the reason for the increasing uncollectables is due to the inefficiency of public debt collection operations, when compared to private operations.

Findings from a variety of General Accounting Office reports document the relative inefficiency of the public sector debt collection operations. For example, in 1976, one agency reported that it spent $8.72 per account to initiate and pursue collection while one of the largest private collection agencies performed the same function for $3.50 per account in the same year. In addition, private firms reported that it was profitable to pursue collection on debts as small as $25, while the Federal Government typically wrote off debts when less than $600. In addition, the Federal Government reported that it required a minimum of one year, and frequently much longer, to obtain a judgment against a debtor. Private firms, on the other hand, obtain judgments in about five months. This relative slowness in collection for the Federal Government simply means that it must incur opportunity costs (carrying charges) on accounts receivable much longer than the private sector.

Payroll.—In testimony before the Joint Economic Committee, J. Peter Grace, Chairman of the President's Private Sector Survey (PPSS) on Cost Control, indicated that it cost the U.S. Army $4.20 to process a payroll check. He stated that the same function was performed by private firms for $1.00 per check.

Social Security Medicare Payments.—General administrative functions have become very computer sensitive. In the area of automated data processing (ADP), the Federal Government has fallen behind the private sector. Today, approximately 50 percent of the Government's 17,000 computers are so old that they are no longer supported by the manufacturers. Consequently, they must be maintained by specially trained government personnel. The Federal Government's ADP system led to high cost and slowness. This is particularly noteworthy in the processing of the Federal medicare claims.

Studies have found that to process a Medicare claim in 1971 and 1972, the public cost was 35 and 18 percent higher, respectively, than a comparable private firm. Also, the private firms were found to process claims at a faster rate and with a lower error rate than the public sector.

Custodial Services and Building Maintenance

The Grace Commission's evaluation of the Federal Government's custodial services revealed that the General Services Administration employs about 17 times as many people and spends about 14 times as much as private firms to deliver comparable building maintenance.

Other studies report that facilities maintenance at selected military facilities was reduced by 35 percent, when these functions were transferred to private contractors. They also reported savings in custodial services, when supplied by private firms rather than military. These savings ranged from 5 to 25 percent.

In Germany, analyses show a similar situation to that in the United States. Private custodial services for government offices in Hamburg were between 30 and 80 percent less costly than public custodians. And for the Federal Post Office system, private custodians were between 30 and 40 percent less costly than public ones.

Electricity

There has been a great deal of systematic analysis of electric utilities in the United States. These studies support the notion that private firms are more productive than public firms, and that these comparative cost differentials exist in spite of the fact that private utilities' pricing and investment policies are heavily regulated.

Typical of the productivity and cost studies is a comparison of Federal and private hydroelectric plants. Table X.1 summarizes the results for comparable private and public operations.

TABLE X.1.—COST PER KILOWATT HOUR (KWH) IN PUBLIC AND PRIVATE HYDROELECTRIC PLANTS

Type of plant	Avg. employ./plant 1973–75	Avg. employ./generator 1973–75	Cost/kWh of installed capacity
Public	14.4	4.1	$3.29
Private	9.7	2.8	2.79

Source: General Accounting Office, FSMSD–79–15, May 29, 1979.

Forestry

There are over 90 million acres of publicly owned commercial forest lands in the United States that are managed by the U.S. Forest Service. These lands generate negative cash flows of about $1 billion per year. Private timberlands, on the other hand, typically generate positive cash flows.

Analyses of forest lands in West Germany reveal the same picture. Public forests were reported to have negative cash flows of 30

DM per hectare, while private forests registered positive cash flows of 15 DM per hectare.

The inefficient management of public forest lands results from nonoptimal cutting practices, inappropriate rotation ages, and excessive costs. For example, the cost of preparing a sale of stumpage by the U.S. Forest Service can be as high as $80 to $100 per 1,000 board feet, while the same activity on private lands can be accomplished at a cost of $10 per 1,000 board feet.

Military Support and Maintenance

The U.S. Defense Department contracts with private providers for many base support and maintenance services. A sample of these activities has found that private providers performed the same quality and quantity of services at an average cost savings of 15.1 percent, with savings that ranged from 0.1 percent to 35 percent.

The PPSS has also reported findings that are consistent with those mentioned above. Since 1960, the Air Training Command (ATC) has contracted with a private firm to perform base support services for Vance Air Force Base in Enid, Oklahoma. Performance standards in the contract specified what the private contractor was to do, but not how it was to do it. The private contractor, by using less manpower, more specialized personnel, flexible procurement policies, and a stable work force has been performing its contract at 22 percent less cost than Federal employees. The private firm at Vance, for example, uses 40 and 27 percent, respectively, less manpower to maintain T-38 and T-37 training aircraft than does the ATC for its system-wide remaining publicly maintained T-38's and T-37's. Using fewer personnel, the private firm also provides a higher quality service than does the public sector. The private firm only has 18.8 percent of the T-38's and 14.3 percent of the T-37's out of operation for maintenance on the average, compared to 21.5 percent and 15.4 percent, respectively, for the ATC public system. The private firm has 87.3 percent of its T-38's and 94.4 percent of the T-37's that it maintains fully mission capable, compared to 84 percent of the T-38's and 92.5 percent of the T-37's for the ATC publicly maintained planes.

Postal Services

Even though private, first-class mail statutes prohibit private firms from competing with the U.S. Postal Service for this class of service, many private providers have led the way in adopting innovative postal technology and have also been able to deliver a higher quality service at a lower cost than the U.S. Postal Service.

For example, United Parcel Service (UPS) handles twice as many parcels as the U.S. Postal Service, charges lower rates, makes faster deliveries, and has a damage rate that is 80 percent less than the public post office. In addition, UPS makes a profit, whereas the U.S. Postal Service has typically generated losses.

Further evidence of private enterprise's relative efficiency in the field of postal service has been provided by the PPSS. The PPSS reported that it cost the U.S. Postal Service, on the average, $0.24 per dollar of revenue generated to operate a postal window at a public post office. Alternatively, the U.S. Postal Service contracts out with private enterprise to operate postal windows at a much lower cost. For example, in 1981, the U.S. Postal Service in Tucson, Arizona, had 23 private contract stations, and the cost per dollar of revenue generated at these stations was only $0.028.

Perhaps the best evidence of the relative quality and efficiency of private providers of postal service is attested to by the extremely rapid growth of private providers. Further deregulation in the postal field would, no doubt, lead to even more private firms and more growth in the private sector.

Prisons and Correctional Facilities

Since 1979, the Federal Bureau of Prisons has contracted out all of its halfway-house operations. Some States have done the same. The Immigration and Naturalization Service has begun to contract out for some of its lock-up facilities. In all, there are some 30,000 juvenile offenders housed in about 1,500 facilities that are owned and operated by private firms.

The evidence reported indicates that private firms have been able to build and operate low security facilities at costs that are 10 to 25 percent less than public facilities. Moreover, they can complete the design and construction of these facilities in six to twelve months as opposed to an average of five years for the public sector.

The reality of these private prison cost savings has recently been recorded in Houston, Texas, where a private firm built and now operates a 350-bed holding facility for the Immigration and Naturalization Service for $24 per day per prisoner. This is about 35 percent lower than the public cost.

Railroads

Remarkably low productivity, when compared to similar private lines, has been reported for public railroads. Amtrak removed 71.8 miles of rail with an average crew of 129, while the average removed by the private firms was 344 miles with an average crew of 71. The average private firm surfaced 864 miles of track with an 18-man crew, compared to Amtrak's 141.1 miles with a 16-man crew. These comparative productivity data are summarized in Table X.2.

TABLE X.2.—OUTPUT PER HOUR, BY FUNCTION, AMTRAK VERSUS PRIVATE FIRMS

Function	Amtrak	Private firms				
		1	2	3	4	Average
Wood Tie Removal Ties/Labor Hour	0.5	2.10	2.39	2.29	2.18	2.24
Rail Renewal Track Ft/Labor Hr	1.13	5.52	4.42	6.75	N/A	4.92
Surfacing Tract Ft/Labor Hr	21.17	N/A	38.40	36.81	70.40	48.54

Source: General Accounting Office.

Wastewater

Wastewater provision in the United States is a particularly interesting area, since it reveals how budget and tax policies can influence the provision of public service. Federal involvement in the wastewater treatment issue dates back to the 1950's. President Eisenhower believed that water pollution control was important and should be financed by those causing the pollution.

Congress, taken with the argument that the Federal Government should subsidize the contruction of wastewater facilities, opposed the President. In 1956, it overrode his veto and passed the Federal Water Pollution Control Act.

The original program was rather modest—$50 million a year was appropriated for the entire country and a limit of $250,000 was placed on any single project. But succeeding Congresses raised the ante dramatically, and the program grew out of control. By 1972, Congress had amended the Act and increased the annual authorization to $4.5 billion a year, an 8900 percent increase over the 1956 level, with the Federal Government picking up 75 percent of the cost for eligible projects. In less than three decades, the so-called "Construction Grants Program" ballooned into the Nation's largest public works effort.

While the program might be well intentioned, it basically has become a giant, wasteful, pork-barrel operation. Independent professionals have criticized it. In fact, the National Commission on Water Quality has recommended its end, and last year the Water Pollution Control Board called for its orderly phaseout.

The amendments to the program enacted under the Reagan Administration in 1981 lowered the total annual authorization to $2.4 billion a year and reduced the coverage and the Federal cost-share to 55 percent of eligible projects.

New tax laws in 1981 offered two provisions which greatly enhanced the attractiveness of private investment in wastewater facilities: investment tax credits and the accelerated cost recovery system. These translate into lower costs and prices for goods and services provided from new private investments.

The arithmetic of reduced subsidies for public projects and tax benefits for private investments tilted the balance toward the private ownership, construction, and management of wastewater service. The key factor that tipped this balance was the inherent cost advantage associated with the private supply of wastewater services.

Because of construction and operating efficiencies, the cost of private supply typically run 20 percent to 50 percent lower than public supply. These cost savings result from the fact that it only takes about two to three years to design and construct a private plant, whereas a public plant requires seven to eight years. In addition, public plants must follow the U.S. Environmental Protection Agency's design criteria, which result in "overdesigned" plants. The public plants must also often pay construction workers wages that are higher than market wages because of the requirements of the Davis-Bacon Act. Last, competition and private ownership put pressure on private firms to efficiently operate plants, whether they be public plants that have been contracted out for operation or plants that are privately owned.

One of the most recent examples of how private wastewater plants save money is found in Chandler, Arizona, a 45,000-person community located 35 miles southeast of Phoenix. This plant was designed, financed, owned, and is operated by Parsons Corporation. The City of Chandler has determined that it will save 37 percent relative to what it would have cost to build and operate a public plant. Furthermore, Chandler will preserve its debt capacity for other purposes.

Recently, the tax committees of Congress have expressed concern over the tax benefits that private firms receive for providing wastewater services to tax-exempt entities. Some members of the tax committees want to close the alleged tax loopholes of investment tax credit and rapid depreciation. They argue that this will save the government money. However, the tax benefits, which are granted to wastewater plants and are the same as any other private investment, amount to about 25 percent of the present value of the cost of a private wastewater plant. So, one can argue that the "cost" to the Federal Government of a private plan is 25 percent of the plant. However, if these tax benefits were disallowed and the plants were built publicly, with a construction grant, the Federal Government would pay 55 percent of the plants' cost and the plant would cost about 50 percent more to build. So, the arithmetic is clear: assume the private plant cost $10 million, then the tax benefits would equal $2 million; alternatively, a public plant would cost $15 million and the Federal grant would be $8.25 million.

The point here is that the inherent advantage of private provision can either be enhanced or crippled by tax and budgetary (cost-sharing) considerations. These factors must always be carefully considered when attempting to assure that public services and infrastructure are supplied at the least cost.

Weather Forecasting

The weather forecasting at National Airport in Washington, DC, has been contracted out to a private firm. The contract contains incentive for accurate forecasts, with payments being reduced for below average forecasts in any month and grounds for contract default if two consecutive below average months occur. The cost savings from this privatization has been 37 percent and the quality of the forecasts improved.

CONCLUSION

Over the years, we have gradually but steadily transferred the responsibility for financing, supplying, and managing a staggering number of services from the private sector to the government sector. Numerous case studies have documented that, where the same or similar services are being offered by both private and public entities, the private sector alternative proved the most cost effective.

The Joint Economic Committee has documented some of the waste and inefficiency in the public sector and has identified some of the symptoms of our problem. One solution is for the Government to copy the management techniques that are employed in the private sector. But political incentives are not the same as those in private enterprise. Public reforms that have attempted to imitate the private sector have not generally been successful and they cannot solve the problem.

The Congress and the Administration should begin a concerted long-term effort to systematically transfer, from the Government to the private sector, services which private enterprise can provide in a more cost-effective manner.

ADDITIONAL AND SEPARATE VIEWS

ADDITIONAL VIEWS OF SENATOR STEVEN D. SYMMS

I support the Republican views in the Joint Economic Committee Annual Report but I have some additional points I want to make with reference to Chapter X, "Privatization in the Federal Government."

During extensive hearings in May and September 1984, by the JEC Subcommittee on Monetary and Fiscal Policy, which I chair, a number of activities that are candidates for privatization were reviewed, with the same conclusion on all of them—that private organizations can produce the same goods and services at lower costs than can the Federal Government. Three areas, in addition to those discussed in Chapter X, that deserve special mention are: Air Traffic Control, Ship Maintenance, and Hospitals and Health Care. I also offer a proposal for partial privatization of social security which could, over time, save substantial sums for the Federal Government, as well as contribute to the soundness and solvency of the social security system.

AIR TRAFFIC CONTROL

Air traffic control in the United States has been dominated by the Federal Aviation Administration (FAA), although private firms have operated smaller airports whose traffic did not qualify them for an FAA tower. All this changed in 1981, when the Professional Air Traffic Controllers' Organization, a public union, called a strike of public controllers. This gave the private controllers an opportunity to expand their business, and it also presented an opportunity for cost comparisons.

This situation has been reviewed, and it was concluded that the public air traffic control system has had a troubled history with outdated technology, a lack of cost-effectiveness, unresponsiveness to users needs, an absence of long-range planning, political interference, and labor problems.

For comparable towers (the smallest FAA authorization), the FAA spends about $1 million to install and about $275,000 per year to operate and maintain. Private firms provide the same services for about $120,000 per year, including amortization of their original capital investments.

SHIP MAINTENANCE

Many of the Navy's support ships are similar and perform functions that are identical with the private merchant marine. The General Accounting Office reviewed comparative performance and cost data on public versus private fleets. They reported that private ships were typically on sea duty between two and three and one-half times more than the public fleet. So, the private output per ship was much higher than public output. Given that the output per ship was higher, one would expect that the total maintenance costs per ship would have been higher for the private fleet. However, this was not the case.

The average annual maintenance cost for a Navy support ship was $2 million, whereas a private ship was $400,000. Furthermore, more disaggregated data for eight specific equipment repair items revealed the public cost for the identical job ranged from 3 to 52 times more expensive than private vessels. These cost data are also supported by data on days per year that are required for repair: naval support ships spent between 30 to 68 days per year in repair, whereas private vessels spent between 11 and 31 days in repair.

HOSPITALS AND HEALTH CARE

The Federal Veterans' Administration (VA) operates the largest health care system in the United States. The VA operates 172 hospitals, 93 nursing homes, 227 outpatient clinics, 16 domiciliary units, 73 extended care wards in hospitals, and 50 satellite clinics.

The VA system has been extensively studied. The President's Private Sector Survey on Cost Control (PPSS) found that the VA system was highly inefficient when compared to either not-for-profit or for-profit private hospital systems.

For example, sample PPSS data on construction costs (Table 1) show marked differences between VA hospitals and not-for-profit university hospitals.

TABLE 1.—CONSTRUCTION COSTS—V.A. AND UNIVERSITY HOSPITALS

Hospital	Year completed	Number of beds	Construction cost/bed
Duke University	1980	616	$97,400
University of Florida	1983	452	122,800
University of Louisville	1982	264	115,200
University of Chicago	1980	470	117,900
University of Utah	1981	300	140,000
VA Bronx, NY	1980	702	153,000
VA Albuquerque, NM	1983	445	208,000
VA Minneapolis, MN	1984	725	298,000
VA Houston, TX	1986	986	320,000

Source: PPSS, Report on Privatization, 1983.

The construction costs for VA nursing homes were found to also be much higher than for comparable not-for-profit and profit nursing homes. For example, the PPSS compared the construction costs for six VA nursing homes with five comparable nursing homes constructed by a private firm that operates a chain of nursing homes. Table 2 summarizes this comparable construction costs data.

TABLE 2.—CONSTRUCTION COSTS—VA AND PRIVATE NURSING HOMES

Nursing homes	Construction cost/bed		
	High	Low	Average
VA	$113,000	$38,000	$61,500
Private	21,600	12,400	15,900

Source: PPSS: Report on Privatization, 1983.

Over-administration, caused by using the property rights theory of the firm, plagues the VA construction program. The PPSS found that—when compared to the Hospital Corporation of America, the largest private hospital system in the United States—the VA construction administration staff is about 16 times larger, while the construction programs that they administer are roughly the same. As a result, administration costs account for 8 percent of the total construction costs in the VA system, and only 2 percent for the private Hospital Corporation of America. It is important to mention that the VA's over-administration of the construction projects does not result in more rapid completion of projects. In fact, the length of time between project initiation and completion is seven years for the VA, and two years for the Hospital Corporation of America.

Another factor that contributes to the high VA construction costs is the VA's use of standard rather than performance specifications. Standard specifications define contracts so that contractors have no options in the use of materials, methods, and workmanship, etc. Performance contracts, which are typically used by private hospitals, only indentify the terms and degree of service required. Performance contracts, in short, allow the contractor to determine the best method to accomplish a given objective. This not only allows for cost effectiveness in the construction phase per se, but it also reduces the contract administration staff.

These differing types of contracts relate back, again, to the theory of property rights. A bureaucrat, not owning the assets of the bureau or agency, can increase his or her wealth by, among other things, increasing the number of public employees under his or her control. This results from the fact that civil servants' salaries are positively correlated to the number of employees that they supervise, and the total size of their bureau or agency's budget. So, the management level bureaucrats in the VA's construction administration operations have an incentive to negotiate standard, rather than performance, contracts because the former require more VA personnel. The fact that these standard contracts lead to relatively high construction costs, of course, is of no conern to the public bureaucrats, since they do not own the VA and, moreover, the taxpayer "owners" have little incentive to monitor bureaucrats' activities.

The PPSS also evaluated operating costs. As was the case with construction costs, the VA's operating costs were much higher than either not-for-profit or private for-profit hospitals and nursing homes. For example, the average costs for an episode of acute inpatient care at VA hospitals was 69.8 percent higher for medical and 48.0 percent higher for surgical care than not-for-profit hospitals affiliated with medical schools.

The VA has claimed that the reason for their higher costs is the nature of their case mix. For example, the VA treats more psychiatric and other chronic conditions which require long hospital stays. After adjusting a 1982 VA comparative cost study for deficiencies uncovered by the General Accounting Office, the PPSS found that the VA's own analysis, which allegedly normalized the VA costs and not-for-profit hospitals' for case mix, concludes that the VA's operating costs were higher than the not-for-profit hospitals. For example, the not-for-profit hospitals had a 24.3 percent advantage for a medical episode, a 5.9 percent advantage for a surgical episode, and a 15.5 percent advantage overall.

One reason for the comparatively high operating cost in the VA system is the relatively long lengths-of-stay (LOS) in the VA system. For example, the average LOS for the U.S. system was 27.3 days in fiscal year 1981, while the average in the private hospital system is 7.2 days. It is important to mention that the LOS cuts across all types of high-incidence diagnosis. (See Table 3.)

TABLE 3.—AVERAGE LENGTH OF STAY BY DIAGNOSIS FOR MALES (50 TO 64 YEARS)

[In days of stay]

Type of diagnosis	VA	Average length of stay not-for-profit teaching hospital
Cancer of Trachea, Bronchus, Lung	24.9	11.5
Diabetes Mellitus	24.1	9.4
Acute Myocardial Infarction	18.6	19.4
Chronic Ischemic Heart Disease	15.7	11.0
Congenitive Heart Failure	18.5	12.5
Hemorrhoids	8.0	6.9
Chronic Bronchitis	22.2	9.0
Pulmonary Emphysema	24.1	9.9
Stomach Ulcer without Hemorrhage or Perforation	21.5	9.0
Ulcer of Duodenum without Hemorrhage or Perforation	21.2	8.9
Inguinal Hernia without Mention of Destruction	12.5	6.1
Cirrhosis of Liver	24.4	13.0

Source: PPSS: Report on Privatization, 1983.

The use of long length of stay by public bureaucrats is, of course, something we would predict by using the property rights theory of the firm. The long LOS is an inviting technique for a bureaucrat to increase his total budget, employees under his command, and, consequently, his salary.

Another factor contributing to public hospital inefficiency is the high level of medical supply inventories. The VA system's inventory levels are 45 to 60 days. This is 33 to 50 percent higher than typical inventory levels for private hospitals. One reason for the lower private inventory levels is the fact that private owners must pay, either directly or indirectly, for the capital carrying charges on medical supply inventories. Therefore, if inventories for a given level of service are excessive in a private hospital, the asset value of the hospital declines and the private owner's wealth is reduced. Hence, private owners have an incentive to monitor employees so that inventories are properly managed.

Public hospital supply procurement is not cost effective, when compared to private purchases of supplies. The VA, in 1981, purchased 41.9 percent of its supplies at the local level through open market purchases. The remaining 58.1 percent were purchased through national contracts. By comparison, private systems purchase 75 to 85 percent of their supplies through national contracts. For the same products, this saves the private system 20 percent relative to what they would pay if they would have purchased locally in the same proportion as the VA system.

The VA system does contract out for some private nursing home care. The VA contracting cost averages $45 per day. For comparable service within the VA system, the cost is about 2.4 times higher, or $109 per day.

SOCIAL SECURITY REFORM AND PRIVATIZATION

Though the subject of social security reform was not part of the subcommittee hearings on privatization, I have an idea for partial privatization of this expensive major program that I believe deserves the consideration of the Joint Economic Committee, the Congress, and the Administration.

In 1983, Congress passed legislation to rescue social security from a severe financial crisis. Despite this legislation, and the heavy costs it imposed on broad segments of society, social security remains plagued by deep problems.

Current Problems

In the short run, based on the Social Security Administration's (SSA's) own projections in the latest annual reports for the program, social security remains vulnerable to yet another financial collapse. Such a collapse is likely to result if another serious recession develops soon, particularly if inflation is renewed as well. The SSA also projects that the Hospital Insurance (HI) portion of the program will likely be unable to pay benefits by the end of the decade in any event. If any surpluses from the rest of the program are used to bail out HI, the program as a whole will remain vulnerable to collapse due to periodic cycles of inflation and recession. Indeed, if it is assumed that the program's trust funds could borrow from each other as needed, then the SSA's projections indicate that the program will be unable to pay all promised benefits by the mid-1990's under the so-called pessimistic set of assumptions which, in the past, has always been closest to the real experience as it developed. Moreover, some of the key elements of the 1983 rescue legislation, such as the taxation of benefits and payroll tax increases, are unlikely to raise all the revenue projected under the traditional, official, static analysis, contributing to further financial problems.

Over the long run, SSA projections indicate that, in order to pay all the benefits promised to young workers entering the work force today, total social security tax rates may have to be raised to at least 33 percent of total salary, compared to 14 percent today. This would mean a total annual social security tax of $6,700, split between employer and employee, for a worker making $20,000. Many observers believe that these are the more realistic long-run SSA projections. Indeed, former Social Security Chief Actuary, A. Haeworth Robertson, warns that even this may not be enough, suggesting that payroll tax rates may have to climb over 40 percent to pay all the benefits promised to today's young workers.

Perhaps the most discouraging of all, however, is that, even if all the benefits promised to today's young workers are somehow paid, the program will still be unattractive for these workers. This is true even though today's retirees are still getting a good deal from the program.

Those retiring in the early years of social security only had to pay the program's taxes for a few years before retirement, and the initial taxes were quite low. The maximum annual social security tax, including both the employee and employer shares, was $189 as late as 1958, and $348 as late as 1965. The benefits received by these early retirees consequently represented a high return on their social security tax dollars.

But, as workers retired who had paid higher taxes for more of their working careers, this return began to fall. Today's retirees are still receiving above-market returns through the program. But those entering the work force today must pay social security taxes of several thousand dollars a year for their entire working careers. The maximum annual tax today is almost $5,600, and will be near $8,000 by the end of the decade.

Recent studies indicate that, for most of these young workers, the benefits they are promised for these high tax payments will represent a low, below market, real rate of return of 1 percent or less. For maximum-income workers and most two-earner couples—a large proportion of this rising generation—the real return will be zero or even negative. If these workers could invest funds equal to the social security taxes to be paid by them and their employers to expand "Super Individual Retirement Accounts (IRA's)," they could expect much higher returns and benefits than promised by social security.

Still another major problem is that the program's benefit structure is grossly inequitable. Workers are not paid equal returns on past taxes paid into the program. Two workers paying the exact same taxes in their careers can receive widely differing benefit amounts. Blacks and other minorities tend to receive lower returns from the program due to their below average life expectancies. They are subject to the same taxes as everyone else throughout their careers, but tend to live far fewer years in retirement to collect benefits. A white male at birth can expect to live 50 percent longer in retirement than a black male at birth. In addition, blacks, as a population group, are significantly younger than whites. Since the program is less attractive the younger one is, it discriminates against the black population relative to the white one.

The social security payroll tax also seriously damages the economy, destroying jobs and economic growth. To the extent the tax is borne by employers, it discourages them from hiring. Either way, the result is less employment and, consequently, less output. The payroll tax is nothing more than a tax on employment and here, as elsewhere, the result of taxing something is that there is less of it.

For at least half of all workers covered by social security, the total combined payroll tax is more than they pay in Federal income tax. In 1983, payroll tax revenues, drawn primarily from low- and moderate-income workers, were over 70 percent greater than total Federal, corporate, and business tax revenues. Given the Nation's high priority concern regarding employment opportunities, this huge tax burden on labor is highly dubious. Yet, without fundamental reform, the future may hold in store sharp payroll tax increases.

Proposal for Reform—Super IRA's

The solution to these and the many other serious problems plaguing social security does not in any way require imposing sacrifices on the elderly. Quite to the contrary, appropriate reform would strengthen social security and assure today's elderly their benefits, while providing a more secure and prosperous retirement for today's young workers, and the opportunity to work in a more healthy and rapidly growing economy.

To accomplish this, Congress should, first of all, attempt to solve the short-term HI crisis without any benefit cuts, by providing that any surplus from Old Age and Survivor's Insurance (OASI) portion of social security can be used to finance HI benefits. This could ensure the payment of HI benefits into early in the next century, when long-term reforms can take hold. If adverse economic performance and/or less-than-projected revenue flows cause a shortfall before then, the severity of any necessary corrective measures will have been sharply reduced in any event.

In addition, Congress should pass legislation providing all retirees with a social security bond contractually entitling them to their promised benefits. In accordance with legislatively expressed congressional intent, this would give each retiree the same legal status as a U.S. Treasury bond holder. It would then be unconstitutional to cut the social security benefits of someone once they retire, just as it is unconstitutional to refuse to repay a U.S. Treasury bond.

For today's workers, Congress should legislate an option for them to substitute expanded "Super IRA's" for part of their social security coverage. This would involve allowing workers to contribute to their IRA's each year, on top of any other amounts they may contribute under current law, an additional amount up to a maximum equal to 20 percent of their OASI taxes. Instead of the usual IRA income tax deduction for these contributions, however, workers would instead receive a dollar-for-dollar income tax credit equal to the amount of such contributions. Workers would also be allowed to direct their employers to contribute up to 20 percent of the employer share of the OASI tax to their IRA's, with each employer, again, receiving a full income tax credit for these amounts.

Workers who utilize this credit option would then have their future social security retirement benefits reduced to the extent they did so. A worker who opted for the full credit during his entire working career would have his retirement benefits reduced by 20 percent, which would be the maximum reduction. A worker who regularly took half the credit each year would have his future benefits reduced by 10 percent. Workers could take the credit in some years and not others, and in differing degrees each year, with a proportional formula to calculate the resulting benefit reductions. In retirement, of course, the accumulated funds in the Super IRA's would pay benefits which would more than make up for the foregoing social security benefits.

It is important to recognize that, since the tax credit is taken against income taxes rather than payroll taxes, social security revenues would continue to flow into the program in full to finance benefits for today's elderly. The credit option would simply result in a loss of income tax revenue. If the credit option were in effect in the current fiscal year (FY 1985), and workers utilized it twice as much as they currently use conventional IRA's, the income tax revenue loss for the year would be $14.5 billion.

This loss would eventually be offset completely by reduced social security expenditures, as more and more workers retired, relying to a large extent on Super IRA's rather than social security. Long before this point, however, the lost revenue would be replaced by savings through the Super IRA's, at least equal to the amount of the revenue lost, since the credit is only allowed for Super IRA savings. So even if the Government had to borrow entirely to cover the temporary net revenue loss, there would be no net increase in the Government borrowing drain on private savings.

Starting on a later date, workers would be allowed to contribute further amounts to their IRA's each year, up to a maximum of 10 percent of the employee's OASI taxes, for the purchase of private life insurance. Workers could also, again, direct their employers to contribute up to this amount to their IRA's for such purchases. Both employer and employee would, again, each receive an income tax credit equal to the amount of these contributions, instead of the usual IRA deduction.

An employee with no dependents, who may not need such life insurance coverage, would be allowed to devote these additional contributions to his retirement benefits instead. With only one dependent, the employee would be allowed to use half of these contributions for retirement.

Social security currently pays survivors' benefits on behalf of a deceased taxpayer who leaves a dependent spouse and young children, or an elderly spouse, as survivors. For workers under 65, private life insurance can entirely perform this function. Consequently, a worker who died before 65 would have his survivors' benefits reduced to the extent he had used the tax credit option to purchase private life insurance in force when he died.

Once again, this credit is taken against income taxes rather than payroll taxes and, consequently, social security revenues would continue to flow into the program in full. If this credit option were in effect in the current fiscal year and workers utilized it twice as much as they use IRA's now, the income tax revenue loss for the year would be $7 billion. This loss would be offset rapidly by reduced social security expenditures, since starting in the very first year all those who died while relying on insurance purchased through the Super IRA option would have their survivors immediately receiving private insurance benefits rather than social security benefits. The fully funded private life insurance system would also produce new investment, savings, and tax revenues to offset the temporary income tax revenue loss in the meantime.

Later, the credit options could be expanded further, until workers had the complete freedom to choose how much to rely on Super IRA's or social security. Workers could be allowed to purchase disability and retirement health insurance, as well as life insurance, through Super IRA's, to cover the full panoply of benefits by social security. But an initial reform package would begin with just the elements described above.

Benefits of Reform

Such reform would greatly strengthen social security itself, and probably eliminate the program's current long-term financing problems. This is because, while the program's payroll tax revenues are maintained in full, the program's future expenditures would be reduced markedly as workers relied more and more on Super IRA's rather than social security. With the Super IRA option eventually expanded to the maximum, social security expenditures would likely be reduced dramatically, allowing room for sharp reductions in payroll tax rates.

The reform would not cut benefits for the elderly, today or tomorrow, in any way. It would attempt to bridge the inevitable, short-term, HI financing problem without such cuts. In addition, the retired elderly would have their benefits constitutionally guaranteed through the proposed social security bonds. The elderly would, of course, also benefit from the long-term strengthening of social security financing described above.

At all times, workers who desired would have the complete freedom to rely entirely on social security as is, without bothering with the Super IRA's. Those already in the work force today, who opted for the Super IRA's in whatever degree, would receive full credit toward social security benefits for amounts they paid into the program in the past.

Those workers who did opt for the Super IRA's could expect much higher retirement benefits. These benefits would also be completely equitable, with each worker receiving back in benefits what he paid in contributions, plus interest, on an actuarial basis.

National savings would be sharply increased through the funds paid into Super IRA's, with a fully expanded Super IRA option potentially producing hundreds of billions of increased savings each year. Such a savings increase would, in turn, produce new jobs and substantial increases in economic growth. Eventual payroll tax reductions would also stimulate job creation and economic growth. Moreover, as workers across the whole economy accumulated substantial assets in their Super IRA's, the national distribution of wealth would tend to become more equal. Through this asset accumulation, workers would be developing a substantial ownership stake in America's business and industry.

Finally, as the reform reduced social security expenditures through reliance on Super IRA's, Federal spending would be markedly reduced. With a completely expanded option to rely on Super IRA's, Federal spending on social security could potentially be reduced by one-fourth.

SEPARATE VIEWS OF REPRESENTATIVE OLYMPIA J. SNOWE

I am in general agreement with the economic conclusions of the Republican Views on the Economic Report of the President. I find, however, that I sharply disagree with the exclusively free-trade conclusions and recommendations in the International Trade Section. As such, I am not able to sign the report.

The effects of high trade and budget deficits on the economy warrant immediate attention, since failure to address these problems could lead to high interest rates and inflation, thereby crippling our strong economy. While Congress appears willing to act to reduce government spending, we should also pay close attention to our trade problems, in order to maintain our country's economic health.

Trade

In the United States, frustration about trade problems is running high, and congressional sentiment is at a crossroads. The magnitude of the problem was revealed in January by the Commerce Department when it announced that in 1984 the United States ran a record trade deficit of $123.4 billion, nearly double the previous record of $69.4 billion just a year earlier.

The threat of economic devastation due to surging imports is no longer limited to a few regions or a few major products. Nearly all manufacturing sectors and many primary products were hit in the last year by import competition. My home state of Maine is a microcosm of what our misguided trade policies are doing to the U.S. economy. The major industries of Maine—shoes, lumber, fish, potatoes, textiles, and apparel—are all threatened by imports, and U.S. trade laws have proven inadequate even when foreign subsidies and unfair trade practices are readily apparent.

I disagree with the excessive free-trade orientation of the Republican Views. Since World War II, U.S. trade policy has been to work toward free trade. As a result of this policy, we have opened wide our domestic market to imports, but the world market remains far from free. It is no longer tolerable for us to remain the international dumping ground for imports. In order, as the Reagan Administration has viewed, to get "tough on trade," we must do exactly that: it is time that we began looking out for our own industries.

America's difficult bilateral trade relationship with Japan is all too typical of the treatment we have received at the hands of our international trading partners. Japan, the second largest domestic market in the world, has assiduously protected its own industries from imports. Even U.S. Trade Representative Brock, during testimony before the JEC, admitted that his efforts since 1981 to open the Japanese market to U.S. products have been largely futile. Ambassador Brock has succeeded, after torturous and lengthy negotiations, in getting the Japanese to agree to remove a number of specific barriers to U.S. exports. The practical result, however, has been nil: since 1981, U.S. exports to Japan have remained stagnant, while Japanese imports have boomed. The Japanese continue to devise ever more ingenious barriers to U.S. exports, often disguised as domestic regulations.

The unfortunate reality is that the Japanese—like most of our trading partners—only want to import primary products that they can manufacture and sell abroad at a substantial profit, usually in the United States. By acquiescing to an unfair regime on international trade, the United States is allowing its manufacturing industries to wither and our economy is forced to concentrate ever more on services and primary production.

I do not dispute the theoretical attraction of the concept of free trade. I believe, however, that current policies cannot lead the world closer to an economic utopia that apparently only we have sought. Such policies are leading only to the devastation of our own industries. Rather than allowing other countries to continue using the U.S. domestic market merely as an engine to fuel their own economic growth, we should consider protecting our own industries, and think first about our own economic health. The United States should do all it can to encourage other countries to end their barriers to U.S. goods and services. To encourage this process, I believe that Congress must strengthen U.S. trade remedy laws to give teeth to the efforts of our negotiators, and also work to provide emergency relief to those domestic industries whose health and existence are threatened by the continuing unchecked surge of imports.

Agriculture

I strongly support the Republican position on the state of American agriculture in this 1985 Annual Report. Current farm programs are pushing the full-time family farms out of existence and, if this trend continues, American agriculture will only consist of large "agribusiness" firms and part-time "hobby" farms. Full-time family farmers are being slowly pushed out of the American rural landscape. As we look to the 1985 farm bill to reduce the scope and cost of our Federal farm programs, we must also fashion these programs to meet the needs of farms of all sizes. In addition, we must take an approach that recognizes farmers who aren't producing the major government-supported commodities but who contribute significantly to the life and blood of rural America.

Finally, I believe our farm programs need to enhance U.S. market expansion overseas. American farmers now find themselves in an international marketplace. Our major commodity programs have turned agriculture into big business and, as these policies have encouraged overproduction and surpluses, American consumers, taxpayers, and policymakers have found reason to quarrel with the lost objectives of farming in America.

There is no question that American agriculture is important to the overall economy, and vital to rural economies. Agriculture is responsible for 20 percent of the country's gross national product and 20 percent of our jobs. In rural areas like Maine, agriculture is a way of life as well as livelihood. In these rural areas, the effect of a downturn in prices or an increase in interest rates can be devastating for entire communities. Putting agriculture in this larger picture should become an important objective for policymakers if we are going to make a serious effort to establish a sensible and sensitive farm policy.

The economics of farming are changing rapidly and, as we move through this transition, we must also look at what we are doing to farms of all sizes. In the Northeast, small scale and specialty farming is in jeopardy due, in part, to a lack of support offered for specialty crops and because our major government farm programs reward the economics of size and volume. These output-oriented programs are putting thousands of small family farms which grow a number of specialty crops at a significant disadvantage, and in a position of decline.

The economics of agricultural trade show that we are at the dawn of a new era. While the value of our farm exports was approximately $38 billion in 1984, an important component of the U.S. balance of trade overall, the task of developing new markets overseas is becoming increasingly difficult. Without question, the national deficit, the high value of the dollar, and the expansion of foreign competition are three basic obstacles in the way of improving the economic health of American agriculture. In addition, our major agricultural policies have encouraged overprotection, while also pricing our commodities above world market prices.

At the same time, our farmers are increasingly finding themselves competing at a disadavantage because of the subsidizing practices of many foreign nations. While the Administration continues to work toward the removal of trade impediments, progress has been agonizingly slow in some cases. Serious negotiations are required on bilateral levels and at a mutilateral level (through a new round of the GATT negotiations with our major trading partners) to allow American farmers to fairly compete in their own marketplace and in foreign marketplaces.

In sum, American agriculture is in trouble. The national economy is directly affected by agricultural trade as a contributor to our overall balance of trade. But entire agricultural industries are affected by trade impediments with other nations, and entire communities depend on farming as a livelihood. The cost and lack of flexibility of our major farm policies are also factors which shape the economics of farming and the effect of farming on the economy. However, rather than taking a pessimistic view of the state of agriculture in America, I believe we must respond to the challenge of this situation by drafting legislation that meets the needs of the agriculture economy as well as the individual circumstances of farms of all sizes. The 1985 farm bill needs to take a long-range approach to agriculture by reducing the cost and size of our major commodity programs, expanding agriculture export-incentive programs, and constructing a more flexible system that will keep the full-time family farmers in business. I look to the 1985 farm bill to put us on this long-range, sensible path to improve agriculture in the United States.

Women in the Work Force

Another issue not addressed by either the Democratic or Republican reports is the changing role of women in the work force, a glaring oversight given the composition of the work force today.

In 1984, 53.9 percent of adult women were either working or looking for work. Between 1947 and 1980, the number of working women increased by 173 percent. Of these workers, the greatest increase in participation was among women with children. In 1983, for the first time, half of all mothers with children under age six were in the labor force and, by March 1984, nearly half of all women with children under 3 were also employed.

In 1983, families maintained by women accounted for 16 percent of all families in the United States, up five percentage points from 1970. Of these female-headed families, 36 percent lived in poverty, compared with 7.8 percent of all families. The median income for female-headed families was $11,789 in 1983. Married couples had a median income of $27,286, despite the fact that the cost of maintaining both households was approximately equal. Further compounding their precarious financial status is the fact that less than 60 percent of single mothers are awarded or have an agreement to receive child support payments. Of these women, less than half (47 percent) receive full payment, 25 percent receive partial payment, and 28 percent receive nothing at all.

This somewhat cursory statistical picture of American women has tremendous implications for the economy as a whole and for the development of public policy responsive to the needs of families. Clearly, the continuation of economic and domestic policies based solely on the traditional, single-wage earner American family seriously threatens the economic security of countless women and children.

During the 98th Congress, I chaired a series of four Joint Economic Committee hearings on the subject of women in the work force. The first hearing focused on a 1983 Census Bureau report, "American Women: Three Decades of Change," which documented the changes over the past 30 years in women's marriage and childbearing ages and rates, educational attainment, wages and income, and household composition. One of the most striking findings of the report was the fact that, despite two decades of Federal legislation, the wage gap between working men and women actually widened between 1955 and 1981.

A later hearing focused entirely on the question of wage discrimination and pay equity. The Equal Pay Act of 1963, which guarantees women equal pay for equal work, has not been sufficient to reach the wage discrimination that most women experience because, by and large, women do not work in the same jobs as men. As they did a century ago, most women remain segregated into a small number of low-paying dead-end jobs. In fact, 80 percent of all working women work in just 25 job classifications—jobs that are among the lowest paid in our society. And numerous studies, including the landmark National Academy of Sciences report entitled "Women, Work, and Wages," have indicated that the pay women receive appears to have far less to do with the work they do than with the fact that they are women.

In 1981, the Supreme Court made clear that the legal guarantees in Title VII of the Civil Rights Act are broader than those in the Equal Pay Act, and indeed, extend to cases where the work being done by men and women is not substantially equal. The concept of pay equity recognizes simply that discrimination exists not only when people are paid differently for doing the same work but when they are paid differently by their employer for work that requires similar skill, effort, and responsibility. This form of wage discrimination is illegal under Title VII of the Civil Rights Act, and it will continue to be one of the most important economic issues of the decade for women.

Finally, the dual role women play as wage earners and as caregivers, and the employment and retirement income security problems of older women workers, was also considered during hearings before the Committee. The critical need for adequate child care services was of foremost concern. Despite the fact that more than 23 million children in the United States currently require day or after school care, in 1982 there were federally supported day care slots for only 500,000 children. In addition, a woman's caregiving responsibilities frequently do not cease when her children are grown, but rather change to accommodate an aged parent or a sick spouse. The passage of legislation to expand the dependent care tax credit and make it refundable would greatly enhance the ability of low- and middle-income families to secure quality care for their children. It is also important to encourage the use of respite care by caregivers of elderly and disabled family members as a means of avoiding expensive institutionalizations.

The need for training and education opportunities, together with appropriate support services, was identified as a key ingredient in helping poor women break the cycle of welfare and low-wage employment and develop long-term self-sufficiency. Among older women, the Committee considered the effects of a lifetime of job segregation, wage discrimination, and the difficulties of balancing work and family responsibilities on their retirement income security. More than 2.6 million older women had incomes below the poverty level in 1983. Nearly one in every two older women had an income of less than $5,000 in 1983, while less than one in five men had a similar income. As the aging population continues to grow, the lack of retirement income security for older women will require a careful analysis of existing public and private pension policies.

Congress has before it legislation to reform the vesting, integration, and portability requirements of private pension plans that will greatly improve the ability of working women to earn adequate pension benefits. Other legislation currently before Congress would implement an earnings sharing plan under social security, and amend the Tax Code with respect to spousal IRA's and the single head of household zero bracket amount, two areas in which women are the primary losers under the existing Tax Code. The guarantee of economic equity for women will depend on an economy that works, a renewed effort to end discrimination against women in the workplace, and the development of sound economic and domestic policies, such as those described above, that recognize the realities of women's lives.1

VIEWS ON THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

DEMOCRATIC VIEWS ON THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

The Full Employment and Balanced Growth Act of 1978 established national numerical goals for unemployment and stable prices. The Act also charged the Joint Economic Committee with the responsibility of reporting on the goals adopted by the President and the policies recommended to achieve them.

In the first Economic Report of the President following the signing of the Act (the 1979 Report), the Act required the President to develop a five-year timetable to reduce the rate of unemployment to 4 percent (3 percent for individuals 20 and older). Over the same time period, inflation was to be reduced to 3 percent. The ultimate goal of the Act was to maintain full employment while reducing the rate of inflation to zero.

Although the Act did not contain other numerical targets, the President was also required to establish short-term (two year) and medium-term (three-year to five-year) goals for employment, production, real income, and productivity. (Sec. 3(a)(2)(A).) The Act labeled trade deficits a ". . . major problem . . ." and stressed the need to balance the budget.

The framers of the Act placed a heavy emphasis on the importance of the private sector in achieving national economic goals. In meeting the unemployment goals, the first priority was ". . . the expansion of conventional private jobs . . ." and the second was the ". . . expansion of private employment through Federal assistance." The Congress complemented this emphasis on growth in the private sector by passing the Revenue Act of 1978 which contained a number of incentives for private-sector investment. In reporting under the Act, the President is required to include an Investment Policy Report which would evaluate the impact of government policy on the availability of investment capital. (Sec. 207(b).) In addition, the Government was to adopt fiscal policies that keep ". . . the share of gross national product accounted for by Federal outlays at the lowest level consistent with national needs and priorities."

THE PRESIDENT'S 1985 ECONOMIC REPORT

The President's Economic Report, in 1979, the first following passage of the Full Employment and Balanced Growth Act of 1978, devoted 28 pages to meeting the requirements of the Act. The Report specified an economic path that would meet the medium-term goals of the Act, discussed the question of meeting both the unemployment and inflation goals at the same time, and included an Investment Policy Report.

The 1985 Economic Report of the President takes a very different approach and, in fact, adheres neither to the spirit nor the letter of the Act. In the course of a two and one-half page discussion of the outlook for 1985 through 1990, the Economic Report simply mentions that the Full Employment and Balanced Growth Act requires an Investment Policy Report—the reader is then referred to separate sections of the Economic Report. There is no discussion of short-term or medium-term goals or of how to achieve them; the Report merely notes in passing that the Administration's forecast (for 1985 and 1986) and the Administration's medium-term projections (for 1987 through 1990) ". . . . show substantial progress toward achieving the goals specified in the Act."

The Joint Economic Committee cannot comment on goals and policies that have not yet been proposed. What the Committee can do is to assess the extent to which the economy has moved toward the Full Employment and Balanced Growth Act goals and the degree to which the Administration's forecasts and projections move the economy in the same direction.

Employment and Unemployment

Over the past decade, the American economy has generated millions of new jobs. In the four-year period from 1977 through 1980, the economy generated a net increase of more than 10 million jobs. After 1980, the upward trend slowed markedly with the creation of 5.7 million new jobs. Despite the slowing trend, the American performance compares favorably with other industrialized countries—particularly those in Europe. It should be noted that the bulk of the new jobs was in services where the average wage is well below the average in manufacturing. The Joint Economic Committee has asked the Bureau of Labor Statistics to provide accurate data on the wage levels of the new jobs.

Despite the millions of new jobs, there has been much less progress in reducing the civilian unemployment rate to the 4 percent level, and here the recent experience contrasts sharply with what occurred in the 1960's. Over the course of the 1960's, the unemployment rate dropped two full percentage points from 5.5 percent in 1960 to 3.5 percent in 1969. Unemployment crept upward in the 1970's—reaching a yearly high of 7.7 percent in 1976 and settling at 5.8 percent for 1979. In the 1970's, there was a disturbing tendency for each recovery to reach a peak with a higher rate of unemployment than the preceding recovery. At the same time, inflation plateaued at higher rates in the trough of each recession.

Unemployment has remained historically high throughout the 1980's. The official civilian unemployment rate started with an average 7.1 percent rate for 1980, rose as high as 10.7 percent in November of 1982, and has now fallen to the 7.3 percent recorded in February of this year. There are still 8.4 million Americans looking for jobs that cannot find them, an increase of 681,000 over the level at the end of 1980. In addition, there are 5.3 million Americans working part time because they cannot find full-time work. Another 1.3 million would like work but have given up looking because the prospects appear so bleak.

By any measure, unemployment remains a serious economic problem for the country. The country is faced with a high level of unemployment that has been unequally distributed by region, occupation, and race. In fact, the disparity between black and white unemployment has widened markedly over the last decade. In the early and mid-1970's, the black unemployment rate was approximately twice the white rate—for 1973–1976, the black rate stood at 12.2 percent versus 6.0 percent for whites. The ratio between the black and white rates rose to about 23.1 in the 1970's. Since that time, the blacks have had the worst of both worlds: a continuation of the high black-white ratic and a rise in the black unemployment rate to a four-year average of 17.5 percent.

Unemployment continues to be a serious problem among other specific groups. Many older manufacturing workers displaced by foreign trade and technological change have been unable to find work. The black teenage unemployment rate reached a peak of 48.5 percent in 1983, and in February of this year it still exceeded 45 percent. So many black teenagers are not in the labor force that fewer than one in four actually holds a job. The unemployment rate among Hispanics has remained at or near double-digit levels despite the strength of the recent recovery.

The high levels of unemployment show up in personal loss and disillusionment, in budgetary expenditures for unemployment compensation and welfare, and in the billions of dollars of foregone production that would come with full or even fuller employment.

Inflation

Despite the rapid pace of the recovery, inflation did not rise above the 4 to 5 percent level. This more than any other factor provided hope that the recovery would continue to remain strong through the remainder of 1985 and into 1986 and beyond.

A variety of factors contributed to the overall moderation in the pace of inflation. The worldwide recession of 1981 and 1982 significantly cut oil consumption as did various energy conservation steps taken by government, corporate, and private consumers since the mid-1970's. Food prices have also risen slowly over the past four years. A drop in foreign demand coupled with the strong dollar have reduced the overseas market for U.S. farmers. At the same time, domestic production has continued to grow.

The strong dollar has also contributed to the good performance on inflation. Recent testimony before the Joint Economic Committee indicated that the dollar is overvalued by 30 percent. Some economists put the figure even higher. As a result, imports (roughly 11 percent of GNP) are considerably cheaper than they would be with a more competitive dollar. (Because of various trade restraints, not all imports are affected equally by the strong dollar.) In addition, some 70 to 80 percent of U.S.-manufactured products face foreign competition. In effect, the strong dollar makes imports cheaper and keeps many domestic prices down at the same time.

Perhaps the most important structural change in the economy relative to prices was the fact that wage expectations remained low during 1984 despite the strength of the recovery. Several factors probably played a role in leading workers to accept less than might ordinarily be expected—the severity of the 1981–1982 recession, the persistence of high unemployment, and the slowing of inflation itself. Progress against inflation does not mean that the possibility of renewed inflation has disappeared. At some point, the strong dollar is likely to come down. Imports will rise in price and so may some domestic goods that compete with imports. Americans should not have to be reminded that unexpected political events overseas can sharply raise the price of imported oil.

Looking Ahead: Unemployment and Inflation Over the Next Five Years

The Administration has not set employment goals for the next five years or specifically described how it would reach such goals. It has only made forecasts and projections that cover the period from 1985 through 1990. The Administration's forecasts and projections are reproduced below as Table I.

TABLE I.—ADMINISTRATION ECONOMIC ASSUMPTIONS, 1985–90

[Calendar years]

Item	1985	1986	1987	1988	1989	1990
			Level			
Employment (millions) [1]	109.1	111.3	113.5	115.8	117.7	119.4
Unemployment rate (percent) [2]	7.0	6.9	6.6	6.3	6.1	5.8
			Percent Change			
Consumer prices [3]	4.1	4.3	4.2	3.9	3.6	3.3
Real GNP	3.7	4.0	4.0	4.0	3.9	3.6
Real compensation per hour [4]	.3	1.3	1.8	2.7	2.9	3.1
Output per hour [4]	1.5	1.6	1.7	1.8	2.2	2.4

[1] Employment series includes resident Armed Forces.

[2] Unemployment as percent of labor force. See footnote 1.

[3] For urban wage earners and clerical workers.

[4] Nonfarm business, all persons.

Source: "1985 Economic Report of the President," Feb. 5, 1985, p. 64.

If the Administration's optimistic projections prove to be correct, the economy would make progress toward lowering unemployment and reducing inflation. According to Administration projections, unemployment will fall to 5.8 percent in 1990 and inflation (as measured by the consumer price index) will fall to 3.3 percent.

Although such progress would be positive, the 1990 projections still fall far short of the goals specified in the Full Employment and Balanced Growth Act of 1978. Unemployment would still be 1.8 percentage points above the long-term goal specified in the law. At 3.3 percent, inflation would be three-tenths of one percentage point (0.3) above the interim goal and 3.3 percentage points above the long-term inflation goal of zero percent.

The projections of the Congressional Budget Office for the same period are less optimistic than those of the Administration. The CBO forecasts and projections are reproduced below as Table II.

TABLE II.—CONGRESSIONAL BUDGET OFFICE ECONOMIC ASSUMPTIONS, 1985–90

	1985	1986	1987	1988	1989	1990
Real GNP, percent change	3.5	3.2	3.3	3.4	3.4	3.4
GNP deflator, percent change	3.6	4.6	4.4	4.2	4.2	4.2
Civilian unemployment rate	7.1	6.9	6.7	6.6	6.4	6.2
3-month Treasury bill rate	8.3	8.7	8.2	8.2	8.2	8.2

Source: Congressional Budget Office, "The Economic and Budget Outlook: Fiscal Years 1986–1990," Feb. 6, 1985, p. xiv.

The CBO foresees inflation (as measured by the GNP deflator) rising slightly to reach a 4.2 percent rate in 1990. Unemployment inches down by about two-tenths of 1 percent a year to reach 6.2 percent at the end of the decade. If the future looks more like the CBO projections than those of the Administration, the country will be further from the 4 percent unemployment and 3 percent inflation goals.

The CBO projections assume that ". . . real GNP and labor productivity will grow at rates precisely equal to their average growth in the eight-year periods following earlier postwar recessions." The Administration's projections are based on a combination of assumptions about the growth in the labor force and the growth of productivity in the nonfarm business sector. Crucial to their higher growth rate is a more optimistic assumption about productivity growth. In the Administration's view, productivity growth from 1985 to 1990 will return to the 2.0 percent per year average recorded between 1948 and 1981. This rate is well above the 0.7 percent per year for the 1973–1981 period and slightly ahead of the 1.9 percent rate of the 1981–1984 period.

Can the economy do better? Could faster growth bring the economy closer to full employment and stable prices? The high growth alternative of CBO suggests that we can make further progress on the unemployment front but only at the expense of more than doubling the inflation rate, unless major improvements are made in policies to address structural unemployment. (See CBO: *The Economic and Budget Outlook: Fiscal Years 1986–1990,* pp. 44–46.)

Structural Policies

The Full Employment and Balanced Growth Act of 1978 recognized the limits of overall economic policy. Title II of the Act lists a number of policies that could be used to deal with structural unemployment.

In any circumstances, the ability to achieve long-term full employment and stable prices will require a substantial commitment to education and training. Complaints that a large portion of the American work force has not mastered the basic skills needed for modern industrial life and the growing number of unfilled positions in a number of technical specialties both point to a need for greater emphasis on education. The Administration is moving in the opposite direction. By concentrating its budget cuts in the relatively small portion of the budget devoted to personal security and investments in the future, like education, the Administration is effectively ignoring the millions of structurally unemployed Americans and lowering the long-term economic potential of the country as well.

Conclusion

The Administration has emphasized rapid growth as a key to lowered unemployment. Their projections, if realized, would move the economy in the right direction of lower rates of unemployment and lower rates of inflation. They do not, however, meet the goals established by the Act.

Legal requirements of the Full Employment and Balanced Growth Act of 1978 have not been met. Goals for unemployment and inflation have not been set. Nor have policies been spelled out that would attack the continuing problem of unacceptably high unemployment.

Even if Administration growth projections were met, the country would still have millions of Americans looking for work who could not find it. Because the ultimate responsibility of an economic system is to provide for economic growth and the fulfillment of individual potential, it is all the more important to explore alternative macroeconomic and microeconomic policies that will bring the country much closer to truly full employment.

REPUBLICAN VIEWS ON THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

The Full Employment and Balanced Growth Act of 1978 established the numerical goals of 4 percent unemployment and 3 percent inflation for a combined so-called "misery index" of 7 percent. In 1980, this index stood at 19.4 percent—7.0 percent unemployment and 12.4 percent inflation. In 1984, the index rate was 11.4 percent—7.4 percent unemployment and 4.0 percent inflation. In January 1985, the index was 10.9 percent—7.3 percent unemployment and 3.6 percent inflation. Some view the goals of the Full Employment and Balanced Growth Act of 1978 as illusory, unattainable, and "pie-in-the-sky." Others of us have greater faith in the strength of our economic system. While we do not support the arbitrary and largely political legislating of economic goals, the economic programs designed and implemented by the Reagan Administration over the last four years have brought the goals of the 1978 Act within reach.

We believe a generation of real economic growth and rising employment opportunities is attainable. This will require further strengthening of policies which reduce Federal spending, taxation, and regulation, and raise private-sector savings, investment, and self-reliance. This policy guideline must be coupled with a stable monetary policy which will accommodate growth. The policy must also provide a free-market environment promoting entrepreneurship, seeking innovative approaches to solving problems, taking risks, and creating new economic opportunities.

To reach our goals, Federal spending must become a declining share of GNP, thus reducing the Federal deficit. Personal saving, as the seed capital for new investment, must be increased as a percent of disposable personal income. Investment in physical and human capital is needed to increase productivity and competitiveness of the economy, promote noninflationary economic growth, expand job opportunities, and raise living standards for all Americans.

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